7

Retirement and Annuity Income

Retirement planning may be the final frontier for achieving substantial tax shelter benefits. For employees, coverage in a qualified employer retirement plan is a valuable fringe benefit, as employer contributions are tax free within specified limits. Certain plans allow you to make tax-free contributions of salary under a salary reduction arrangement. An advantage of all qualified retirement plans is that earnings accumulate tax free until withdrawal.

Along with tax savings opportunities come technical restrictions and pitfalls. For example, retirement plan distributions eligible for rollover are subject to a mandatory 20% withholding tax if you do not instruct your employer to make a direct trustee-to-trustee transfer of the distribution to an IRA or another qualified employer plan.

This chapter discusses tax treatment of annuities and employer plan distributions, including how to avoid tax penalties, such as for premature or excessive distributions. IRAs are discussed in Chapter 8. Retirement plans for self-employed individuals are discussed further in Chapter 41.

Under the rubric of "simplification," previously allowed benefits, such as lump-sum averaging and the death benefit exclusion, have been restricted or eliminated by Congress; the new laws are highlighted in the text.

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Key to Tax-Favored Retirement Plans

Type—	*General Tax Considerations—*	*Tax Treatment of 1996 Distributions—*
Company qualified plan	A company qualified pension or profit-sharing plan offers these benefits: (1) You do not realize current income on your employer's contributions to the plan on your behalf. (2) Income earned on funds contributed to your account compounds tax free. (3) Your employer may allow you to make voluntary contributions. Although these contributions may not be deducted, income earned on the voluntary contributions is not taxed until withdrawn.	If you receive a lump sum, tax on employer contributions may be reduced by a special averaging rule; *see* ¶7.4. If you receive a lump-sum distribution in company securities, unrealized appreciation on those securities is not taxed until you finally sell the stock; *see* ¶7.10. Distributions before age 59½ are generally subject to penalties, but there are exceptions; *see* ¶7.14. Furthermore, a penalty may also apply for distributions exceeding specified ceilings; *see* ¶7.15. Rather than pay an immediate tax, you may elect to roll over a lump-sum payment to an IRA account; *see* ¶7.8. If you decide to collect your retirement benefits over a period of years, *see* ¶7.25.
Keogh or self-employed plans	You may set up a self-employed retirement plan called a Keogh plan if you earn self-employment income through your performance of personal services. You may deduct contributions up to limits discussed in Chapter 41; income earned on assets held by the plan is not taxed. You must include employees under rules explained in Chapter 41.	As a self-employed person, you generally may not withdraw funds until age 59½ unless you are disabled. Premature withdrawals are subject to a 10% penalty. Qualified distributions to self-employed persons or to beneficiaries at death may qualify for favored lump-sum treatment under the rules of ¶7.2. Employees of Keogh plans follow rules of ¶7.2 applied to qualified plans.
IRA	Anyone who has earned income may contribute to an IRA, but the contribution is deductible only if income and coverage requirements are met. Your status as a participant in an employer retirement plan and your income determine whether you may claim a full $2,000 IRA deduction, a partial deduction, or no deduction at all. *See* Chapter 8 for these deduction limitations. Where deductible contributions are allowed, IRAs offer these benefits: (1) deductions of up to $2,000 for single persons, $4,000 for working couples, and $2,250 on a joint return where only one spouse works; and (2) income earned on IRA accounts is not taxed until the funds are withdrawn. This tax-free build-up of earnings also applies where you make nondeductible IRA contributions under the rules of Chapter 8.	You may not withdraw funds without penalty unless you are at least age 59½ or disabled or receive IRA distributions in the form of a life annuity. Premature withdrawals are subject to a 10% penalty. If you delay withdrawals, you must begin to take money out of the account at age 70½; *see* ¶8.14. Distributions are fully taxable as ordinary income; *see* ¶8.8. Special averaging is not allowed. Distributions exceeding $155,000 are subject to a penalty for "excess" distributions; *see* ¶7.15.
SEP	A simplified employee pension plan set up by your employer allows the employer to contribute to an IRA more than you can under regular IRA rules. You do not have to include in 1996 income any employer contributions to your account. If your employer qualifies, you may be allowed to make elective deferrals of salary to the plan, up to $9,500 in 1996; *see also* ¶8.17.	Withdrawals are taxable under rules explained above for IRAs.
Deferred salary or 401(k) plans	If your company has a profit-sharing or stock bonus plan, the tax law allows the company to add a cash or deferred pay plan which can operate in one of two ways: (1) Your employer contributes an amount for your benefit to your trust account. You are not taxed on your employer's contribution. (2) You agree to take a salary reduction or to forego a salary increase. The reduction is placed in a trust account for your benefit. The reduction is treated as your employer's contribution. In 1996, the maximum salary reduction is $9,500. Income earned on the trust account accumulates tax free until it is withdrawn.	Withdrawals are penalized unless you have reached age 59½, become disabled, or meet other exceptions listed at ¶7.14. At the time of withdrawal, the tax on lump-sum proceeds may be computed under the rules of ¶7.2.

Distributions From Qualified Retirement Plans

¶7.1 Retirement Distributions on Form 1099-R

On Form 1099-R, payments from pensions, annuities, IRAs, insurance contracts, profit-sharing, and other employer plans are reported to you and the IRS. Special rules for Social Security benefits are discussed in Chapter 34.

Here is a guide to the information reported on Form 1099-R. A sample form is on the next page.

Box 1. The total amount received from the payer is shown here without taking any withholdings into account. If you file Form 1040, report the Box 1 total on Line 15a if the payment is from an IRA, or on Line 16a if from a pension or an annuity. However, if the amount is a qualifying lump-sum distribution for which you are claiming averaging, use Form 4972; *see* ¶7.4.

If you file Form 1040A, report the Box 1 total on Line 10a if from an IRA, or on Line 11a if from a pension or an annuity.

If a 1996 distribution exceeds $155,000, you generally are subject to a 15% penalty for excess distributions; *see* ¶7.15 for exceptions. If you are receiving the distribution as a beneficiary, you may be entitled to a $5,000 death benefit exclusion; *see* ¶7.28.

If an exchange of insurance contracts was made, the value of the contract will be shown in Box 1, but if the exchange qualified as tax free, a zero taxable amount will be shown in Box 2a and Code 6 will be entered in Box 7.

Boxes 2a and 2b. The taxable portion of distributions from employer plans and insurance contracts may be shown in Box 2a. The taxable portion does not include your after-tax contributions to an employer plan, or insurance premium payments.

If the payer cannot figure the taxable portion, the first box in 2b should be checked; Box 2a should be blank. You will then have to figure the taxable amount yourself. A payment from a pension or an annuity is only partially taxed if you contributed to the cost and you did not recover your entire cost investment before 1996. *See* ¶7.22 (commercial annuity) or ¶7.25 (employee annuity) for details on computing the taxable portion if you have an unrecovered investment.

The payer of an IRA distribution will probably not compute the taxable portion, and in this case, the total distribution from Box 1 will be entered as the taxable portion in Box 2a. This amount is fully taxable unless you have made nondeductible contributions; *see* ¶8.8.

If the payment is from an employer plan and the "total distribution" box has been checked in 2b, *see* ¶7.2 for possible rollover and special averaging options. The taxable amount in Box 2a should not include net unrealized appreciation in any employer securities included in the lump sum or the value of an annuity contract included in the distribution.

Box 3. If the payment is a lump-sum distribution, and you participated in the plan before 1974, the amount shown here may be treated as capital gain; *see* ¶7.5.

Box 4. Any federal income tax withheld is shown here. Do not forget to include it on Line 52 of Form 1040 or Line 29a of Form 1040A. If Box 4 shows any withholdings, attach Copy B of Form 1099-R to your return.

Box 5. If you made after-tax contributions to your employer's plan, or paid premiums for a commercial annuity or insurance contract, your contribution is shown here, less any such contributions previously distributed. IRA or SEP contributions (*see* Chapter 8) are not shown here.

Box 6. If you received a qualifying lump-sum distribution that includes securities of your employer's company, the net unrealized appreciation is shown here. Unless you elect to pay tax on it currently (¶7.10), this amount is not taxed until you sell the securities. If you did not receive a qualifying lump sum, the amount shown here is the net unrealized appreciation attributable to your employee contributions which are also not taxed until you sell the securities; *see* ¶7.10.

Box 7. In Box 7, the payer will indicate if the distribution is from an IRA or SEP and enter codes that are used by the IRS to check if you have reported the distribution correctly, including the 10% penalty for distributions before age 59½.

If you are under age 59½ and the employer knows that you qualify for an exception to the 10% early distribution penalty (¶7.14), such as the exception for separation of service after age 55, your employer will enter Code 2 in Box 7. Code 3 will be used if the disability exception applies. Code 4 is the exception for distributions paid to beneficiaries. If Code 1 is entered, this indicates that you were under age 59½ at the time of the distribution and as far as the payer knows, no penalty exception applies. However, although Code 1 is entered, you may not be subject to a penalty, as where *you* made a tax-free rollover instead of having your employer make a direct rollover under the rules of ¶7.8. If the employer did make a direct rollover, Code G will be entered if the direct rollover was to an IRA, and Code H if to another employer's qualified plan or tax-sheltered annuity.

If you are at least age 59½, Code 7 should be entered.

If you are the beneficiary of a deceased employee, Code 4 should be entered. The 10% early distribution penalty does not apply. If you contribute to a 401(k) plan and are a highly compensated employee, your employer may have to make a corrective distribution to you of contributions (and allocable income) that exceed allowable nondiscrimination ceilings. In this case, the employer will enter Code 8 if the corrective distribution is taxable in 1996, Code P if taxable in 1995, or Code D if taxable in 1994.

If you receive a lump-sum distribution that qualifies for special averaging, Code A will be entered; *see* ¶7.4 for averaging rules.

Box 8. If the value of an annuity contract was included as part of a lump sum you received, the value of the contract is shown here. It

is not taxable when you receive it and should not be included in Boxes 1 and 2a. For purposes of computing averaging on Form 4972, this amount is added to the ordinary income portion of the distribution; *see* ¶7.4.

Box 9. If several beneficiaries are receiving payment from an employer plan total distribution, the amount shown in Box 9a is your share of the distribution.

If you are receiving annuity payments eligible for the simplified method (¶7.26), the payer will enter in Box 9b your total contributions to the plan if this is the first year of the annuity. If this is not the first year, the remaining employee contributions which may be recovered tax-free are shown.

Boxes 10–15. The payer may make entries in these boxes to show state or local income tax withholdings.

¶7.2 Lump-Sum Distributions

If you receive a qualified lump-sum distribution from a company retirement plan or Keogh plan, you may be able to benefit from the following favorable tax elections:

Tax-free rollover to an IRA or another qualified company plan; *see* ¶7.8 for further details.

Special averaging if you were born before 1936 or receive the lump sum after reaching age 59½; *see* ¶7.4 for further details.

Capital gain treatment for gains realized before 1974 and special averaging on the taxable balance of the distribution if you were born before 1936; *see* ¶7.5.

You may be eligible for tax-free rollover but not averaging because of additional averaging conditions discussed in this section under "Lump-sum tests." If you receive a lump-sum distribution and you qualify for both rollover and averaging, *see* ¶7.3. If you do not meet the age test for averaging (¶7.4), a lump-sum distribution will be subject to tax at regular rates unless it is rolled over (¶7.8) to an IRA or other qualified plan.

Distributions from an IRA or redemptions of retirement bonds do not qualify for special averaging or capital gain treatment.

Important: If you are married, you must generally obtain your spouse's consent to elect a lump-sum distribution; *see* ¶7.11.

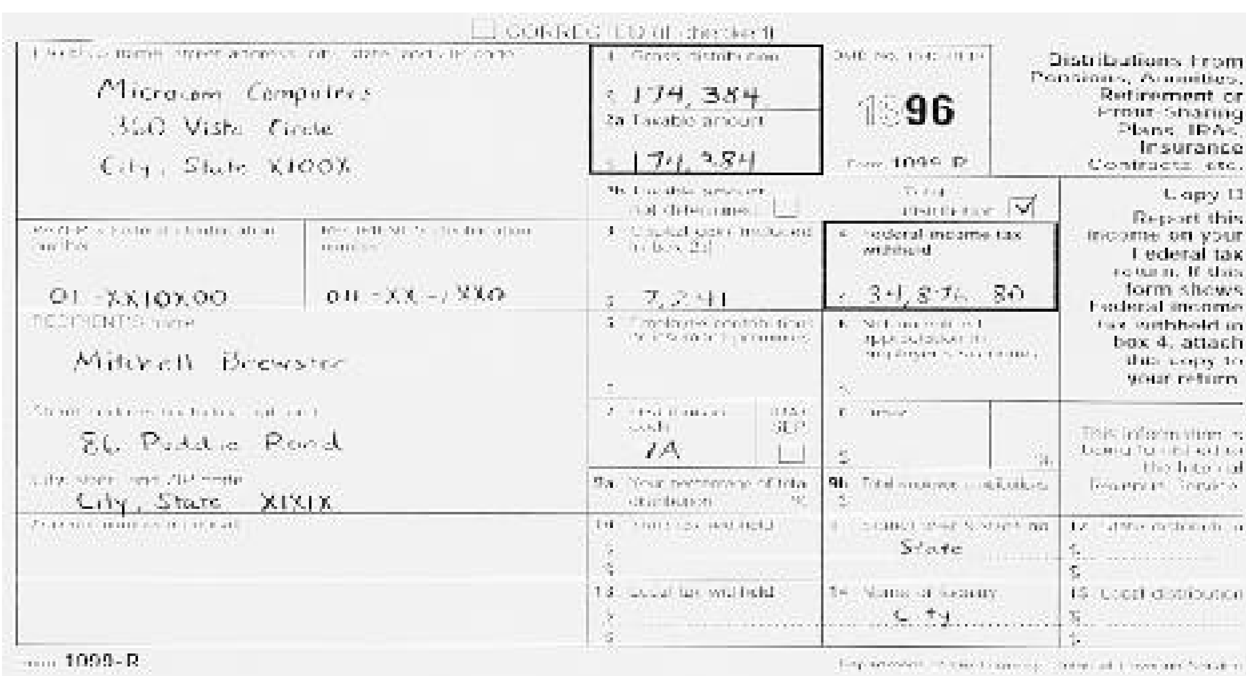
CAUTION

Possible Penalties

You may be subject to a 10% penalty for a lump-sum distribution received before age 59½ that is not rolled over; *see* ¶7.14 for details and exceptions. Furthermore, lump-sum distributions exceeding $775,000 may be subject to a separate 15% penalty for excess distributions, as explained at ¶7.15.

Lump-sums eligible for averaging. For a distribution to qualify as a lump-sum distribution eligible for special averaging (¶7.4), you must have participated in the plan for at least five years before the year of the distribution. Also, the following three tests must be met:

1. Payment must be from a qualified pension, profit-sharing, or stock bonus plan. A qualified plan is one approved by the IRS. A civil service retirement system that has a trust fund may be



treated as a qualified plan. Ask your retirement plan administrator whether the plan qualifies. If your employer has more than one plan of the *same* kind (several pension plans, or several profit-sharing plans, for example) you must receive payment from all of such plans to get lump-sum treatment.

2. If you are an *employee*, the distribution must be made on or after the date you reach age 59½. If you were born before 1936, special averaging options are available; *see* ¶7.4.

   If you are *self-employed*, a Keogh plan distribution qualifies only if made after reaching age 59½, or because you became totally and permanently disabled before age 59½.

3. Within one of your taxable years (usually a calendar year), you must receive the balance of what is due you under the plan. A distribution of only part of your account is not a lump-sum distribution. If your employer's plan uses more than one trust, you must receive a distribution of all that is due you from each of the trusts.

   A series of payments received during one of your tax years can qualify as a lump-sum distribution. For example, you retired on October 15, 1996, and start receiving monthly annuity payments under your company's plan on November 1, 1996. On February 3, 1997, you take the balance to your credit in lieu of any future annuity payments. The payments do *not* qualify as a lump sum; you did not receive them within one taxable year. However, if you had taken the balance of your account on or before December 31, 1996, all the payments would have qualified.

   Lump-sum treatment is not lost if you receive a qualifying lump-sum distribution after separation from service, and in the next year, you receive a payment that is attributable to your last year of work; the later payment is not part of the "balance" that must be received within one of your tax years.

   For purposes of special averaging (¶7.4), accumulated deductible contributions you voluntarily made after 1981 and before 1987 are not considered part of your account balance and do not qualify for averaging.

CAUTION

Prior Rollover Bars Averaging

Even if you receive a distribution that meets the lump-sum tests, you may not claim averaging if you previously received a distribution from the same plan that was rolled over tax free (¶7.8) to an IRA or to another qualified employer plan.

Withholding tax. An employer must withhold a 20% tax from a lump-sum distribution that is paid to you and not rolled over directly by the employer; *see* ¶7.8 for further details.

Beneficiaries. A surviving spouse who receives a lump-sum distribution upon the death of an employee may avoid tax by making a tax-free rollover to an IRA. Beneficiaries other than surviving spouses may not make a tax-free rollover; *see* ¶7.8.

If the deceased employee was born before 1936 or had reached age 59½, any beneficiary (not just a surviving spouse) may elect special averaging or capital gain treatment for a lump-sum distribution of the account; *see* ¶7.7.

Court ordered lump-sum distribution to a spouse or former spouse. A distribution received by a spouse or former spouse of an employee under a qualified domestic relations order (QDRO) may be eligible for tax-free rollover, or, in some cases, special averaging treatment; *see* ¶7.12.

¶7.3 Should You Average or Make a Rollover?

If you receive a lump-sum distribution but are not eligible for averaging, you may avoid current tax by rolling over the distribution. To avoid withholding tax on the distribution, you must have your employer directly transfer the distribution to an IRA or qualified plan of another employer. If you receive the distribution, a 20% tax will be withheld. If you later decide to make a rollover, you have 60 days from the time of receiving the distribution to do so; *see* ¶7.8. However, to avoid tax on the entire distribution, you will have to include in the rollover an amount equal to the withheld tax. Withholding is discussed further at ¶7.8 and ¶26.11.

If you *can* average (¶7.4), you should determine whether paying tax currently using the averaging method will be more favorable to you than making a tax-free rollover. If you receive more than one lump sum during the year, you must make the same choice for all of them; you may not roll over one distribution and claim averaging for another.

If you need the lump-sum payout immediately or may need it within a few years, pay tax now using special averaging.

If you qualify for special averaging but do not plan to use the funds until retirement, estimate whether you will build a larger retirement fund by rolling over the distribution and letting earnings accumulate tax free, or by using special averaging and investing the funds to give you the greatest after-tax return. This is not an easy projection. You must consider the number of years to retirement, your expected tax bracket at retirement, and the estimated yield you can earn on your funds. Generally speaking, a person who is not planning to retire for many years may get a greater after-tax return by making a rollover and then taking withdrawals over his or her life expectancy at retirement.

Finally, keep in mind the tax rule that allows you to elect averaging *only once*. If you receive a lump-sum distribution that qualifies for averaging but you plan to continue working, a later lump-sum distribution will not qualify for averaging if you elect averaging for the current distribution. If you make a rollover to an IRA and later join a company with a retirement plan that accepts rollovers (¶7.8), you may transfer the funds to the company plan and averaging might apply when you receive a qualifying lump sum from that plan; *see* the Caution on page 127.

Form 4972—Worksheet

Part II **Complete this part to choose the 20% capital gain election** (See instructions.) Do not complete this part unless the participant was born **before** 1936.

8	Capital gain part from box 3 of Form 1099-R	8	7,241
9	Multiply line 8 by 20% (.20) If you also choose to use Part III, go to line 10. Otherwise, enter the amount from line 9 on Form 1040, line 39, or Form **1041**, Schedule G, line 1b, whichever applies.	9	1,448

Part III **Complete this part to choose the 5- or 10-year tax option** (See instructions.)

10	Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from box 2a of Form 1099-R	10	167,143
11	Death benefit exclusion	11	0
12	Total taxable amount. Subtract line 11 from line 10	12	167,143
13	Current actuarial value of annuity (from Form 1099-R, box 8)	13	
14	Adjusted total taxable amount. Add lines 12 and 13. If this amount is $70,000 or more, **skip** lines 15 through 18, and enter this amount on line 19	14	167,143
15	Multiply line 14 by 50% (.50), but **do not** enter more than $10,000 (15)		
16	Subtract $20,000 from line 14. If the result is less than zero, enter -0- (16)		
17	Multiply line 16 by 20% (.20) (17)		
18	Minimum distribution allowance. Subtract line 17 from line 15	18	
19	Subtract line 18 from line 14	19	167,143
20	Federal estate tax attributable to lump-sum distribution	20	0
21	Subtract line 20 from line 19	21	167,143
	If line 13 is blank, skip lines 22 through 24 and go to line 25.		
22	Divide line 13 by line 14 and enter the result as a decimal	22	
23	Multiply line 18 by the decimal on line 22	23	
24	Subtract line 23 from line 13	24	

5-year tax option

25	Multiply line 21 by 20% (.20)	25	33,429
26	Tax on amount on line 25. Use the Tax Rate Schedule for the 5-Year Tax Option in the instructions	26	6,240
27	Multiply line 26 by five (5). If line 13 is blank, skip lines 28 through 30, and enter this amount on line 31	27	31,201
28	Multiply line 24 by 20% (.20) (28)		
29	Tax on amount on line 28. Use the Tax Rate Schedule for the 5-Year Tax Option in the instructions (29)		
30	Multiply line 29 by five (5)	30	
31	Subtract line 30 from line 27. (Multiple recipients, see page 4 of the instructions.)	31	31,201

10-year tax option

Note: Complete lines 32 through 38 ONLY if the participant was born before 1936. Otherwise, enter the amount from line 31 on line 39.

32	Multiply line 21 by 10% (.10)	32	16,714
33	Tax on amount on line 32. Use the Tax Rate Schedule for the 10-Year Tax Option in the instructions	33	2,851
34	Multiply line 33 by ten (10). If line 13 is blank, skip lines 35 through 37, and enter this amount on line 38	34	28,510
35	Multiply line 24 by 10% (.10) (35)		
36	Tax on amount on line 35. Use the Tax Rate Schedule for the 10-Year Tax Option in the instructions (36)		
37	Multiply line 36 by ten (10)	37	
38	Subtract line 37 from line 34. (Multiple recipients, see page 4 of the instructions.)	38	28,510
39	Compare lines 31 and 38. Enter the **smaller** amount here. ▶	39	28,510
40	Tax on lump-sum distribution. Add line 9 and line 39. Also, enter this amount on Form 1040, line 39, or Form 1041, Schedule G, line 1b, whichever applies ▶	40	29,958

An IRA rollover cannot be revoked to claim averaging. If you make a rollover to an IRA, you cannot change your mind and cancel the IRA account in order to apply special averaging. The rollover election is irrevocable, according to an IRS regulation which has been upheld by the Tax Court. If an IRA rollover account is revoked, the entire distribution is taxable as ordinary income, and a 10% penalty may be imposed if the recipient is under age 59½ (¶7.14).

CAUTION

Five-Year Averaging Repealed After 1999

A new law repeals the right to use 5-year averaging for those born after 1935, starting in 2000. For those born before 1936, the right to use 10-year averaging will not be affected; the 5-year averaging option will not be available after 1999.

Disqualification of retirement plan. If you receive a lump-sum distribution from a plan which loses its exempt status, the IRS may argue that the distribution does not qualify for lump-sum treatment. Under the IRS position, you may not roll over the distribution to an IRA or elect special averaging. The Tax Court previously took the position that if the plan qualified when contributions were made, an allocable portion of the distribution was a qualified lump sum. However, the majority of appeals courts that reviewed Tax Court decisions on this issue supported the IRS position. In response, the Tax Court reversed its position and adopted the harsher IRS approach: no part of the distribution qualifies for rollover or averaging if the plan loses its exempt status.

¶7.4 Averaging on Form 4972

If you meet the age test, and if you were a participant in a qualified company retirement plan or Keogh plan for five or more years before the 1996 taxable year, you may elect averaging on Form 4972 for a 1996 lump-sum distribution meeting the three tests at ¶7.2.

Age test. There are two age tests for averaging and your averaging options depend on which test you meet:

Were you born before 1936? If you were born before 1936, you may elect on Form 4972 either a 10-year averaging method based on 1986 tax rates for single persons, or a 5-year averaging method based on single person rates for the year in which the lump sum is received.

Were you born after 1935? If you were born after 1935, you may elect 5-year averaging for a qualifying distribution made after you reach age 59½. Thus, if you were born in 1936 or the first six months of 1937 and in 1996 a lump-sum distribution was made to you after you reached age 59½, you may elect 5-year averaging for that distribution. Ten-year averaging is not allowed.

If you were born after June 30, 1937, you will not reach age 59½ until 1997 at the earliest and thus a 1996 lump-sum distribution cannot qualify for averaging.

Note: Under a new law, 5-year averaging will not be allowed after 1999.

Averaging on 1996 returns. If you meet the age test and were a participant in the plan for five or more years before 1996, follow IRS instructions to Form 4972 for applying averaging to a qualifying lump-sum distribution received during 1996. If you received more than one qualified lump sum, you may elect averaging for one of the distributions only if you elect averaging for all of them.

The amount eligible for averaging is the taxable portion of the distribution shown in Box 2a of Form 1099-R, minus any death benefit exclusion claimed as a beneficiary. You may also elect to add to the Box 2a amount any net unrealized appreciation in employer securities (shown in Box 6) included in the lump sum.

If you were born before 1936 and the distribution includes capital gain (Box 3 of Form 1099-R) and you want to apply the special 20% capital gain rate (¶7.5), you should subtract the capital gain in Box 3 from the taxable amount in Box 2a and apply averaging to the balance of ordinary income.

Tables for applying the 10-year and 5-year averaging methods are included in the 1996 instructions to Form 4972. In most cases, except where extremely large distributions (over $358,221) are received, 10-year averaging will provide the lower tax.

Whichever averaging method you use, the tax computed on Form 4972 is reported on Form 1040, Line 38, as an additional tax. It is completely separate from the tax computed on your other income reported on Form 1040.

Once in a Lifetime Election

You are allowed to elect averaging only once after 1986. If you elect averaging for a 1996 distribution, you will not be able to claim averaging again if you join another company and receive a lump-sum distribution from the new employer. On the other hand, if you do not claim averaging for a qualifying 1996 lump-sum distribution because you expect to receive another distribution in the future from a new employer, keep in mind the new law that repeals 5-year averaging after 1999; *see* the Caution in the left column of this page.

If before 1987 you elected 10-year averaging and were under age 59½, you may elect averaging for a 1996 distribution. However, if you were over age 59½ when you made the pre-1987 election, you are barred from electing averaging again.

Community property. Only the spouse who has earned the lump sum may use averaging. Community property laws are disregarded for this purpose. If a couple files separate returns and one spouse elects averaging, the other spouse is not taxed on the amount subject to the computation.

EXAMPLE

A husband in a community property state receives a lump-sum distribution of which the ordinary income portion is $10,000. He and his wife file separate returns. If averaging is not elected, $5,000, or one-half, is taxable in the husband's return and the other $5,000 in his wife's return. However, if he elects the averaging method, only he reports the $10,000 on Form 4972.

Pre-1974 capital gain portion of distribution. If a portion of your 1996 lump-sum distribution is attributable to plan participation before 1974 (¶7.5), you may elect to treat it as capital gain if you were born before 1936. The capital gain portion may be treated as ordinary income eligible for averaging, or you may elect to have the capital gain part taxed at a flat 20% rate, with the ordinary income portion of the distribution subject to the averaging computation; *see also* ¶7.5.

If you were born after 1935, you may *not* treat any portion of it as capital gain. You may not apply the flat 20% rate to the pre-1974 portion of the lump-sum distribution, or include any part of it as capital gain on your 1996 Schedule D.

¶7.5 Capital Gain Treatment for Pre-1974 Participation

The portion of a lump-sum distribution attributable to pre-1974 participation is eligible for capital gain treatment if you were born before 1936.

On Form 1099-R, the company paying the lump-sum distribution shows the capital gain portion in Box 3. The ordinary income portion is Box 2a (taxable amount) *minus* Box 3. If you are an employee, capital gain treatment is available to the extent allowed by the following rules, even if you do not elect averaging. If you are self-employed, capital gain treatment is allowed only if averaging is elected for the ordinary income (post-1973) portion.

Born before 1936. You may elect to treat the pre-1974 portion as capital gain subject to a flat rate of 20% on Form 4972. If you meet the five-year plan participation test (¶7.4), the tax on the balance of the distribution may be figured under the averaging method. The 20% rate for the capital gain portion is fixed by law, and applies regardless of the tax rate imposed on your other capital gains. Alternatively, you may elect to treat the capital gain portion as ordinary income eligible for averaging, provided the five-year participation test has been met. You may not elect to report any portion of the pre-1974 portion of a 1996 lump-sum distribution as long-term capital gain on Schedule D.

Under the one-time election rule, if you elect to apply the averaging and/or 20% capital gain rule for a 1996 distribution, you may not elect averaging or capital gain treatment for any later distribution.

Capital gain treatment not allowed for individuals born after 1935. No part of a lump-sum distribution qualifies as capital gain if you were born after 1935. An election to claim capital gain treatment on Schedule D was phased out between 1987 and 1991. If you made such an election, you will not be allowed to claim five-year averaging for a lump-sum distribution received after age 59½.

¶7.6 Lump-Sum Distribution Upon Separation From Service

You may receive a lump-sum distribution from a qualified employer retirement plan when you separate from service, that is, when you resign, retire, or are fired from your job. Your age, not the fact that you have separated from service, determines your right to claim special averaging:

If you are at least age 59½ on the date of the distribution, you may elect either special averaging (*see* ¶7.4) or tax-free rollover treatment (*see* ¶7.8).

If you have *not* reached age 59½ on the date of the distribution, tax-free rollover is allowed but *not* special averaging. If a rollover is not made under the rules of ¶7.8, the distribution is fully taxable and it will also be subject to the 10% penalty for early withdrawals, unless one of the exceptions at ¶7.14 applies.

Restriction on pre-retirement distributions from pension plans. To be a qualified plan under IRS regulations, a pension plan (in contrast to a profit-sharing or stock bonus plan) may permit distributions only upon separation from service or disability. Thus, an employee who reaches age 59½ but continues to work is generally unable to receive a lump-sum distribution from a pension plan. However, under IRS rulings, lump-sum treatment is allowed for a qualifying distribution (¶7.2) made after you have reached age 59½ if you have also reached the *normal retirement age* as defined in the plan, or if the plan has been terminated, even though you have not separated from service.

Separation-from-service test for pre-1996 distributions of individuals born before 1936. Since 1987, a special law has allowed individuals born before 1936 to claim averaging for a lump-sum distribution received *before* age 59½, if the distribution is on account of separation from service. This separation-from-service exception is irrelevant for a lump-sum distribution received in 1996 or later years. If you were born before 1936, any lump-sum distribution received in 1996 qualifies for averaging under the regular age 59½ rule.

If you elected averaging for a lump-sum distribution received following a merger or reorganization but before you were age 59½, the IRS may challenge the election if you continued working for the successor firm. The IRS may argue that there was no separation from service. However, if you can show that there was a substantial change in your job responsibilities following the merger or reorganization, this may be evidence of a separation from service.

¶7.7 Lump-Sum Payments Received by Beneficiary

A beneficiary of a deceased employee may elect special averaging on Form 4972 for a qualifying lump-sum distribution (¶7.2) received because of the employee's death, provided the employee was born before 1936 or was born after 1935 and had reached age 59½. A beneficiary may elect averaging, even though the deceased employee was in the plan for less than five years. Furthermore, the age of the beneficiary is irrelevant.

Either 10-year or five-year averaging may be claimed if the employee was born before 1936. If the employee was born after 1935 and was at least age 59½, five-year averaging may be used. If the employee was born before 1936 and had participated in the plan before 1974, a 20% capital gain election may be elected for that portion of the distribution (¶7.5), and the averaging method applied to the balance.

Form 4972 is used to compute tax under the averaging method or to make the 20% capital gain election (¶7.5). Follow the Form 4972 instructions to claim the up-to-$5,000 death benefit exclusion for a 1996 distribution (¶7.28). Any federal estate tax attributable to the distribution reduces the taxable amount on Form 4972. Any election made as a beneficiary does not affect your right to elect lump-sum treatment for a distribution from your own plan.

A lump sum paid because of an employee's death may qualify for capital gain and averaging treatment, although the employee received annuity payments before death.

An election may be made on Form 4972 only once as the beneficiary of a particular employee. A beneficiary who receives more than one lump-sum distribution for the same beneficiary in the same year must treat them all the same way. Averaging must be elected for all of the distributions on a single Form 4972 or for none of them.

Payment received by a second beneficiary (after the death of the first beneficiary) is not entitled to lump-sum treatment or the death benefit exclusion.

Beneficiaries of self-employed individuals who receive a qualifying lump-sum distribution from a Keogh plan apply the same rules as beneficiaries of deceased employees, as just discussed.

Distribution to trust or estate. If a qualifying lump sum is paid to a trust or an estate, the employee, or, if deceased, his or her personal representative, may elect averaging.

EXAMPLES

1. Gunnison's father was covered by a company benefit plan. The father died, as did Gunnison's mother, before benefits were fully paid out. Gunnison received a substantial lump sum. He argued that he collected on account of his father's death. The IRS disagreed.

   The Tax Court and an appeals court sided with the IRS. Gunnison was entitled to the payment following his mother's death, not his father's death. For special lump-sum treatment, the payout must arise solely on account of the death of the covered employee.

2. Robert's employer announced the termination of its pension plan. Before benefits were distributed, he died. His widow received a lump-sum distribution as his beneficiary. After subtracting the amount attributable to his contributions, she excluded $5,000 as a death benefit and treated the balance as a lump-sum distribution.

   The IRS claimed she received the distribution on the termination of the plan, not because of Robert's death. The Tax Court agreed. The distribution was made to her under the termination provision, not the provisions for withdrawal due to separation-from-service or death. She could not take a death benefit exclusion, and no part of the distribution (less Robert's contributions) could be treated as a lump-sum distribution.

Lump Sums to Multiple Beneficiaries

A lump-sum distribution to two or more individuals may qualify for averaging and capital gain treatment. Each beneficiary may separately elect the averaging method for the ordinary income portion, even though other beneficiaries do not so elect. Follow the Form 4972 instructions for multiple recipients.

¶7.8 Tax-Free Rollovers

Almost all taxable distributions received from a qualified corporate or self-employed pension, profit-sharing, stock bonus, or annuity plan are eligible for tax-free rollover. The major exceptions are your *after-tax* contributions, substantially equal periodic payments over your lifetime or over a period of at least 10 years, and minimum distributions (¶7.13) required after age 70½ ; *see* the next page for other ineligible distributions.

Caution: If you roll over a partial distribution, a later lump-sum distribution from the plan will not qualify for averaging; see ¶7.4.

Rollover options. If you want to make a tax-free rollover of an eligible rollover distribution, you should instruct your employer to directly roll over the funds to an IRA you designate or to the plan of your new employer. You could also choose to have the distribution paid to you, and within 60 days you could make a tax-free rollover yourself. *However, to avoid the 20% mandatory withholding tax, you must elect to have the plan make a direct rollover. If an eligible rollover distribution is paid to you, the 20% withholding tax applies. Your employer must provide you with written notice concerning the rollover options and the withholding tax rules.*

Rollover from employer plan to IRA after age 70½. Starting with the year you reach age 70½, you may no longer make IRA contributions. However, if you are over age 70½ and you receive an eligible rollover distribution from your employer's plan, you may instruct your employer to make a direct rollover of the distribution to an IRA as discussed below. If you receive the distribution from

the employer, a 20% tax will be withheld; you may make a tax-free rollover within 60 days of the distribution; *see* next column for the discussion of "personal rollovers". In the year of the rollover, you must receive a minimum distribution from the IRA; *see* ¶8.13.

Beneficiaries. The only beneficiary who may make a tax-free rollover is a surviving spouse as discussed later in this section.

Distributions that may not be rolled over. Any lump-sum or partial distribution from your account is eligible for rollover *except for the following:*

- Payments that are part of a series of substantially equal payments made at least annually over a period of 10 years or more or over your life or life expectancy (or the joint lives or joint life and last survivor expectancies of you and your designated beneficiary).
- Minimum required distributions after attaining age 70½ (¶7.13).
- Distributions of your voluntary after-tax contributions to the plan. These are nontaxable when distributed to you and thus are not eligible for rollover or subject to withholding.
- Corrective distributions of excess 401(k) plan contributions and deferrals.
- Dividends on employer stock.
- Life insurance coverage costs.
- Loans that are deemed to be taxable distributions because they exceed the limits of ¶7.16.

For all of the taxable distributions that are *ineligible* for rollover, you may elect to completely avoid withholding on Form W-4P.

DIRECT ROLLOVER TO IRA OR ANOTHER EMPLOYER PLAN

If you choose to have your employer make a direct rollover of an eligible rollover distribution to an IRA or another qualified plan, you avoid tax on the payment and no tax will be withheld. If you are changing jobs and want a direct rollover to the plan of the new employer, make sure that the plan accepts rollovers; if it does not, choose a direct rollover to an IRA.

When you select the direct rollover option, your employer may transfer the funds directly by check or wire to the new plan, or you may be given a check payable to the new plan which you deliver.

In choosing a direct rollover to an IRA, the terms of the payer-employer's plan will determine whether you may divide the distribution among several IRAs or whether you will be restricted to one IRA. For example, you may want to split up your distribution into several IRAs, but the employer may force you to select only one. After the direct rollover is made, you may then diversify your holdings by making tax-free trustee-to-trustee transfers to other IRAs.

You may elect to make a direct rollover of part of your distribution and to receive the balance. The portion paid to you will be subject to 20% withholding and is not eligible for special averaging. The IRS allows plan administrators to bar a partial direct rollover if the rollover amount is less than $500.

A direct rollover will be reported by the payer plan to the IRS and to you on Form 1099-R, although the transfer is not taxable. The direct rollover will be reported in Box 1 of Form 1099-R, but zero will be entered as the taxable amount in Box 2a. In Box 7, Code G should be entered if the direct rollover was to an IRA and Code H if to another qualified employer plan or to a tax-sheltered annuity.

PERSONAL ROLLOVER AFTER RECEIVING A DISTRIBUTION

If you do not tell your employer to make a direct rollover of an eligible rollover distribution, and you instead receive the distribution yourself, you will receive only 80%; 20% will be withheld. Withholding does not apply to the portion of the distribution consisting of net unrealized appreciation from employer securities that is tax-free under the rules of ¶7.10.

Although you receive only 80% of the eligible rollover distribution, the full amount is required as a taxable distribution on Form 1099-R. To avoid tax you must roll it over within 60 days to an IRA or another employer plan.However, to roll over 100% of the distribution you will have to use other funds to replace the 20% withheld. If you roll over only the 80% received, the 20% balance will be taxable; *see* the John Anderson Example below. For the taxable part which is not rolled over, you may not use special averaging or capital gain treatment even if you meet the age test of ¶7.4. In addition, if the distribution was made to you before you reached age 59½, the taxable amount will be subject to a 10% penalty unless you are disabled, separating from service after reaching age 55, or have substantial medical expenses (¶7.14).

The rollover amount *may not* include your voluntary after-tax contributions to the qualified plan; they are tax free to you when you receive them. The rollover *may* include salary deferral contributions that were excludable from income when made, such as qualifying deferrals to a 401(k) plan. The rollover may also include accumulated deductible employee contributions (and allocable income) made after 1981 and before 1987. Your employer's retirement plan may invest in a limited amount of life insurance which is then distributed to you as part of a lump-sum retirement distribution. You may be able to roll over the life insurance contract to the qualified plan of your new employer but not to an IRA. The law bars investment of IRA funds in life insurance contracts.

You may not claim a deduction for your rollover to an IRA.

EXAMPLE

In January 1997, John Anderson retires. He is due a lump-sum distribution of $100,000 from a qualified plan of his company. If he instructs his employer to make a direct rollover of the amount to an IRA, there is no tax withholding and the $100,000 is transferred to the IRA tax free.

Now assume that John decides not to choose a direct rollover because he is planning to use the funds to invest in a business. The plan will pay him $80,000 and withhold a tax of $20,000 which John will apply to his 1997 tax liability. But, say, a month later John changes his mind about the investment and now wants to roll over his benefits to an IRA. He must make the rollover within 30 days; that is because 30 days of the 60-day rollover period have already passed. Furthermore, to avoid tax on the entire distribution, he must deposit $100,000 in the IRA, even though $20,000 tax has been withheld. If he does not have the $20,000, he must borrow the $20,000 and deposit it in the IRA. If he rolls over only $80,000, he must report $20,000 as a taxable distribution on his 1997 return and if John is under age 59½, the 10% penalty (¶7.14) for early withdrawals may apply.

Reporting a personal rollover on your return. When you receive a distribution from the old plan, the payer will report as the taxable amount on Form 1099-R the full amount before withholding, although 20% has been withheld. However, if you make a rollover yourself within the 60-day period, the rollover reduces the taxable amount on your tax return. For example, if in 1996 you were entitled to a $100,000 lump-sum distribution and received $80,000 after mandatory 20% withholding and then you rolled over the full $100,000 to an IRA, report $100,000 on Line 16a of Form 1040 or Line 11a of Form 1040A, but enter zero as the taxable amount on Line 16b or Line 11b. If you roll over only part of the distribution, the amount of the lump sum *not* rolled over is entered as the taxable amount. Remember to include the 20% withholding on the line for federal income tax withheld.

Figuring the 60-day period for personal rollovers. A rollover must be completed by the 60th day following the day on which you receive the distribution. The IRS held in a private letter ruling that if in one year you receive several payments, constituting a lump-sum distribution from an employer plan, the 60-day period starts from the date of the last payment. For example, you retired in July 1995 and received a partial distribution from your company plan. You were told that you would receive the balance by December 1995. Provided all payments are received before the end of 1995, the payments received in July and December are considered a lump-sum distribution eligible for rollover. You have 60 days from the date of the final December payment to complete the rollover.

The IRS has strictly applied the 60-day requirement for personal rollovers even where failure to meet the deadline is not the taxpayer's fault. For example, an investor wanted to transfer a lump-sum distribution from a terminated company plan to an IRA. The company plan had been invested in five different funds maintained by a mutual fund "family," and the investor merely wanted to reregister his account as an IRA while keeping the same fund investments. However, his written instructions were followed for only four of the funds because of a clerk's error. The failure to reregister the fifth account was not discovered and corrected until six months later. An unsympathetic IRS held that the amount from the fifth fund, $15,100, was a taxable distribution because it was not rolled over within the 60-day period.

In a similar case, the Tax Court allowed tax-free rollover treatment where Merrill Lynch made a bookkeeping error by failing to properly record a rollover of a lump-sum distribution of cash and stock from a company plan. The cash was deposited into the IRA within the 60-day period but the stock was not. The court held that the date of the rollover was fixed when the taxpayer signed the necessary documentation and transferred the funds to establish the IRA within the 60-day period.

Extension of 60-day rollover period for frozen deposits. If you receive a qualifying distribution from a retirement plan and deposit the funds in a financial institution which becomes bankrupt or insolvent, you may be prevented from withdrawing the funds in time to complete a rollover within 60 days. If this happens, the 60-day period is extended while your account is "frozen." The 60-day rollover period does not include days on which your account is frozen. Further, you have a minimum of 10 days after the release of the funds to complete the rollover.

Multiple rollover accounts allowed. You may wish to diversify a distribution in different investments. There is no limit on the number of rollover accounts you may have. A lump-sum distribution may be rolled over to several IRAs or retirement annuities.

CAUTION

IRA Rollover Election Is Irrevocable

A rollover from an employer plan to an IRA is irrevocable, according to the IRS. At the time of the rollover, you must elect in writing to irrevocably treat the contribution as a rollover. If you roll over a qualifying lump sum, you may not later change your mind in order to claim averaging. Before making a rollover, figure what the current tax would be on the lump-sum distribution under the special averaging method. Compare it with an estimate of tax payable on a later distribution of the rolled-over account.

Consider further that if you make a rollover to an IRA and not to a new employer's qualified plan, you lose the right to apply the special averaging method to the sum, unless the IRA is used as a conduit between two company plans, as discussed on the next page. Special averaging applies only to a lump-sum distribution from a qualified plan. It does not apply to a withdrawal from an IRA account. If you are under the age of 59½, also consider that a rollover to an IRA locks in your funds. If you withdraw funds from the IRA, you may be subject to a penalty; *see* ¶8.12. Other points to consider in deciding whether to roll over a lump sum are discussed at ¶7.3.

ROLLOVER BY SURVIVING SPOUSE

A surviving spouse is the only beneficiary who may make a tax-free rollover. If you are your deceased spouse's beneficiary, you may roll over your interest in his or her qualified plan account. You may choose to have the plan make a direct rollover to your IRA; you cannot make the rollover to your employer's qualified plan. The advantage of choosing the direct rollover is to avoid a 20% withholding. If the distribution is paid to you, 20% will be withheld. You may make a rollover within 60 days, but to completely avoid tax, you must include in the rollover the withheld amount, as illustrated in the John Anderson Example on page 130. If you receive the distribution but do not make the rollover, you will be taxed on the distribution, but if your spouse was born before 1936 or was over age 59½, you may be able to use special averaging (¶7.4) to compute the tax. As a surviving spouse, you are not subject to the 10% penalty for premature distributions (¶7.14) even if you are under age 59½.

Rollover of distribution received under a divorce or support proceeding. In a qualified domestic relations order (QDRO) meeting special tax law tests, a state court may give you the right to receive all or part of your spouse's or former spouse's retirement benefits. You can choose to have the payment made to you or you can instruct the plan to make a direct rollover to an IRA or to your employer's qualified plan if it accepts rollovers. Alternatively, if the distribution is paid to you, 20% withholding will apply. You may complete a rollover within 60 days under the rules for personal rollovers discussed earlier. If you do not make the rollover, the payments you receive are taxable, but you may be able to elect special averaging; *see* ¶7.12. If only part of the distribution is rolled over, the balance is taxed in the year of receipt. In figuring your tax, you

are allowed a pro-rated share of your former spouse's cost investment, if any. You may not elect averaging or capital gain treatment for the portion not rolled over. You are not subject to the 10% penalty for premature distributions even if under age 59½.

Nonspouse beneficiaries. If you are a beneficiary other than a spouse, you cannot choose to have the plan make a direct rollover and you cannot make a rollover yourself if payment is made to you. Distributions must begin under the payment rules for beneficiaries discussed at ¶7.13, unless special averaging is available for a lump-sum distribution of the account; *see* ¶7.4.

IRA Conduit Between Employer Plans

An IRA may be used as a conduit between two company plans. The funds in the IRA may be transferred to another qualified plan of a company which employs you, provided the plan of your new employer accepts rollovers. A qualifying lump-sum distribution from the new employer plan may be eligible for special averaging; *see* ¶7.4. The IRA must consist of only the assets (or proceeds from the sale of such assets) distributed from the first qualified plan and income earned on the account. You may not contribute to the account set up as a conduit. You may set up another IRA to which you make annual contributions. In such a case, you will have two accounts, one consisting of the assets (or proceeds from the assets' sale) of the plan of your prior employer and the other of your own contributions.

EXAMPLE

You leave your employer and receive a lump-sum distribution of $5,000 from his qualified plan to which you did not contribute. You roll over the amount to an IRA. Four years later, you start work for another company that has a qualified plan. The new plan permits you to transfer the assets of the IRA to the plan. You must make the transfer within 60 days after closing the account.

¶7.9 Rollover of Proceeds From Sale of Property

A lump-sum distribution from a qualified plan may include property, such as non-employer stock; *see* ¶7.10 for employer securities. If you plan to roll over the distribution, you may find that a bank or other plan trustee does not want to take the property. You cannot get tax-free rollover treatment by keeping the property and rolling over cash to the new plan. If you sell the property, you may roll over the sale proceeds to an IRA as long as the sale and rollover occur within 60 days of receipt of the distribution. If you roll over all of the proceeds, you do not recognize a gain or loss from the sale; the proceeds are treated as part of the distribution. If you make a partial rollover of sale proceeds, you must report as capital gain the portion of the gain that is allocable to the retained sale proceeds.

If you receive cash and property, and you sell the property but only make a partial rollover, you must designate how much of the rolled-over cash is from the employer distribution and how much from the sale proceeds. The designation must be made by the time for filing your return (plus any extensions) and is irrevocable. If you do not make a timely designation, the IRS will allocate the rollover between cash and sales proceeds on a ratable basis; the allocation will determine tax on the retained amount.

If you made after-tax contributions to the plan, you may not roll over the portion of the distribution equal to your contributions.

¶7.10 Distribution of Employer Securities

When a plan distributes securities of your company, the value of the securities may or may not be subject to tax at the time of the distribution. The amount reported as income depends on the value of the securities, the amount contributed by the company toward their purchase, and whether or not the distribution qualifies as a total lump-sum payment.

Lump-sum payments. If the distribution is of appreciated securities and is part of a lump-sum payment meeting the tests of ¶7.2, the net unrealized appreciation (increase in value since purchase of securities) is not subject to tax at the time of distribution unless you elect to treat it as taxable. Assuming the election to treat the unrealized appreciation as current income is not made, only the amount of the employer's contribution is subject to tax. Tax on the appreciation is delayed until the shares are later sold by you at a price exceeding cost basis. If, when distributed, the shares are valued at below the cost contribution of the employer, the fair market value of the shares is subject to tax. If you contributed to the purchase of the shares and their value is less than your contribution, you do not realize a loss deduction on the distribution. You realize a loss only when the stock is sold or becomes worthless (¶5.7) at a later date. If a plan distributes worthless stock, you may deduct your contributions to the stock as a miscellaneous itemized deduction subject to the 2% of adjusted gross income floor.

The net unrealized appreciation in employer's securities is shown in Box 6 of the Form 1099-R received from the payer. It is not included in the taxable amount in Box 2a.

Election to waive tax-free treatment. You may elect to include the unrealized appreciation in employer securities as income. You might consider making this election when you want to accelerate income to the current year by taking into account the entire lump-sum distribution. The election is made on Form 4972 for the year the distribution is received.

EXAMPLES

1. *Shares valued below your cost contribution*. You contributed $500 and your employer contributed $300 to buy 10 shares of company stock having at the time a fair market value of $80 per share. When you retire, the fair market value of the stock is $40 per share, or a total of $400. You do not realize income on the distribution, and you do not have a deductible loss for the difference between your cost contribution and the lower fair market value. Your contribution to the stock is its basis. This is $50 per share. If you sell the stock for $40 per share, you have a capital loss of $10 per share. However, if you sell the stock for $60 per share, you have gain of $10 per share.
2. *Appreciated shares*. You receive 10 shares of company stock which was purchased entirely with the employer's funds. Your employer's cost was $50 a share. At the time of distribution, the shares are valued at $80 a share. Your employer's contribution of $50 a share, or $500, is included as part of your taxable distribution. The appreciation of $300 is not included, assuming you do not elect to be taxed currently on the appreciation. The cost basis of the shares in your hands is $500 (the amount currently taxable to you). The holding period of the stock starts from the date of distribution. However, if you sell the shares for any amount exceeding $500 and up to $800, your profit is long-term gain regardless of how long you held the shares. If you sell for more than $800, the gain exceeding the original unrealized appreciation of $300 is subject to long-term capital gain treatment only if the sale is long term from the date of distribution. Thus, if within a month of the distribution you sold the shares for $900, $300 would be long-term gain; $100 would be short-term gain.

Other than lump-sum payments. If you receive appreciated securities in a distribution that does not meet the lump-sum tests of ¶7.2, you report as ordinary income the amount of the employer's contribution to the purchase of the shares and the appreciation allocated to the employer's cost contribution. You do not report the amount of appreciation allocated to your own after-tax contribution to the purchase.

EXAMPLE

A qualified plan distributes 10 shares of company stock with an average cost of $100, of which the employee contributed $60 and the employer, $40. At the date of distribution, the stock had a fair market value of $180. The portion of the unrealized appreciation attributable to the employee's contribution is $48 (60% of $80); the employer's is $32 (40% of $80). The employee reports $72 as income: the employer's cost of $40 and share of appreciation which is $32. The basis of each share is $132, which includes an employee contribution of $60 and the $72 reported as taxable income. Net unrealized appreciation and cost contributions must be supplied by the company distributing the stock.

¶7.11 Survivor Annuity for Spouse

If you have been married for at least a year, the law generally requires that payments of vested benefits be in a specific annuity form to protect your surviving spouse. All defined benefit and money purchase plans must provide benefits in the form of a qualified joint and survivor annuity unless you, with the written consent of your spouse, elect a different form of benefit. A qualified joint and survivor annuity must also be provided by profit-sharing or stock bonus plans, unless you do not elect a life annuity payment and the plan provides that your nonforfeitable benefit is payable in full upon your death to your surviving spouse, or to another beneficiary if the spouse consents or there is no surviving spouse.

Under a qualified joint and survivor annuity, you receive an annuity for your life and your surviving spouse receives an annuity for his or her life that is no less than 50% of the amount payable during your joint lives. Unless you obtain spousal consent, you must take this type of annuity; you may not take a lump-sum distribution or a single-life annuity ending when you die. A single-life annuity pays higher monthly benefits during your lifetime than the qualified joint and survivor annuity.

The law also requires that a pre-retirement survivor's annuity be paid to your surviving spouse if you die before the date vested benefits become payable. For example, under a defined contribution plan such as a profit-sharing plan, the pre-retirement annuity payments must be equal to those under a single-life annuity valued at 50% or more of your account balance. The pre-retirement annuity is automatic unless you, with your spouse's consent, agree to a different benefit.

Your plan should provide you with a written explanation of these annuity rules within a reasonable period before the annuity starting date, as well as the rules for electing to waive the joint and survivor annuity benefit and the pre-retirement survivor annuity.

Spouse Must Consent in Writing

Your spouse must consent in writing to any waiver and the selection of a different type of distribution. A spouse's consent must be witnessed by a plan representative or notary public. An election to waive the qualified joint and survivor annuity may be made during the 90-day period ending on the annuity starting date. An election to waive the qualified pre-retirement survivor annuity may be made from the first day of the plan year in which you reach age 35 up until your date of death. A waiver is revocable during the time permitted to make the election.

Exception. These survivor annuity requirements generally do not apply to couples who have been married for less than one year as of the participant's annuity starting date or, if earlier, the date of the participant's death.

Cash out of annuity. If the present value of the qualified joint and survivor annuity is $3,500 or less, your employer may "cash out" your interest without your consent by making a lump-sum distribution of the present value of the annuity before the annuity starting date. After the annuity starting date, you and your spouse must consent to a cash-out. Written consent is required for a cash-out if the present value of the annuity exceeds $3,500. Similar cash-out rules apply to pre-retirement surviving annuities.

¶7.12 Court Distributions to Former Spouse

As part of a divorce-related property settlement, or to cover alimony or support obligations, a state domestic relations court can require that all or part of a plan participant's retirement benefits be paid to a spouse, former spouse, child, or other dependent. Administrators of pension, profit-sharing, or stock bonus plans are required to honor a qualified domestic relations order (QDRO) that meets specific tax law tests. For example, the QDRO generally may not alter the amount or form of benefits provided by the plan, but it may authorize payments after the participant reaches the earliest retirement age, even if he or she continues working.

QDRO distributions to spouse or former spouse. If you are the spouse or former spouse of an employee and you receive a distribution pursuant to a QDRO, the distribution is generally taxable to you. However, you may make a tax-free rollover to an IRA or to a qualified plan, as discussed at ¶7.8. Furthermore, if your spouse or former spouse (the plan participant) was born before 1936 or was over age 59½, a distribution of your entire share of the benefits is eligible for special averaging, provided the distribution, if received by your spouse (or former spouse), would satisfy the lump-sum distribution tests of ¶7.2; *see also* ¶7.4. Transfers from a governmental or church plan pursuant to a qualifying domestic relations order are also eligible for special averaging or rollover treatment.

For these tax rules to apply, the court order must contain specific language required to create a QDRO. The recipient spouse (or former spouse) must be assigned rights to the plan participant's retirement plan benefits, and must be referred to as an "alternate payee" in the court decree. The decree must identify the retirement plan and indicate the amount and number of payments subject to the QDRO. Both spouses must be identified by name and address.

If the above information is not clearly provided in the decree, QDRO treatment may be denied and the plan participant taxed on the retirement plan distributions, rather than the spouse who actually receives the payments.

Distributions to a child or other dependent. Payments from a QDRO are taxed to the plan participant, not to the dependent who actually receives them, where the recipient is not a spouse or former spouse.

CAUTION

Drafting a QDRO

Drafting a QDRO currently involves technical details which legal counsel must carefully review. As practitioners have found the drafting of QDROs troublesome, and courts have disputed the effect of litigated QDROs, a new law may ease the drafting problem by requiring the IRS to provide by 1997 sample language for inclusion in a QDRO that meets tax law requirements.

¶7.13 When Retirement Benefits Must Begin

The longer you can defer taking retirement distributions from your company plan or self-employed Keogh plan, the greater will be the tax-free buildup of your retirement fund. To cut off this tax deferral, the law requires minimum distributions to begin by a specified date.

If you retire before you reach age 70½ but do not immediately begin withdrawals from your account, the distributions must begin no later than April 1 of the calendar year following the calendar year in which you reach age 70½.

By the required beginning date, you must start to receive annual distributions over a period no longer than your life expectancy or the joint life expectancy of you and your designated beneficiary; you may be subject to a 50% penalty if you fail to take the minimum required distribution.

These required beginning date rules apply to distributions from all qualified corporate and self-employed Keogh plans, qualified annuity plans, and Section 457 plans of tax-exempt organizations. The rules also apply to distributions from tax-sheltered annuities (¶7.20) but only for benefits accrued after 1986; there is no mandatory beginning date for tax-sheltered annuity benefits accrued before 1987.

New law allows delay if you work after age 70½. If you continue to work after the year in which you reach age 70½, a new law generally allows you to delay your first required minimum distribution until April 1 of the year following the year of retirement. For example, if you reach age 70½ in 1997 and do not retire until 1999, your first required minimum distribution does not have to be made until April 1, 2000, the year after the year of retirement. This delayed distribution starting date does not apply to those owning a business interest of more than 5%. If you are still working and began receiving annual distributions under the prior law (by April 1 of the year after the year you reached age 70½), your plan may permit you to discontinue the distributions and take advantage of the delay allowed by the new law.

Effect of Waiting Until April Deadline

You have until April 1 of the year after the year in which you reach age 70½ to take your first distribution, or if you continue working until April 1 of the year following the year of retirement. However, if no distribution is taken during your 70½ year, you will have to take two distributions during the following year. For example, if you retire and reach age 70½ in 1996, and delay receipt of your first distribution until between January and April 1, 1997, you must also receive a distribution for 1997 by December 31, 1997. This could substantially increase your 1997 taxable income, and possibly subject more of your Social Security benefits to tax; for further details *see* Chapter 34.

Pre-1984 designations. Individuals who made a special election before 1984 to receive distributions under pre-1984 rules are not subject to the age 70½ rule or the beneficiary distribution methods discussed later in this section.

Governmental or church plans. If you are covered by a governmental plan or church plan, you do not have to begin receiving distributions until April 1 of the year following the later of (1) the year of retirement, or (2) the year in which you reach age 70½.

HOW MUCH MUST YOU RECEIVE AFTER AGE 70½?

All qualified retirement plans, including Keogh plans for the self-employed, are subject to the same distribution beginning date rules. When you retire or begin distributions under the age 70½ beginning date rule, you may spread payments over your life, over the joint lives of yourself and any designated beneficiary, or over a specific period that does not exceed your life expectancy or the joint life expectancies of yourself and any designated beneficiary. To determine your life expectancy, use Table V shown at ¶7.23. For joint life expectancies, *see* the sample table at the end of Chapter 8.

Once you choose your beneficiary and a payment period, the plan administrator should figure the minimum required distributions you must receive annually.

Pay period based on life expectancy. In figuring the payout schedule, the terms of the plan may require that your life expectancy, and the life expectancy of a spousal beneficiary, be recalculated annually. Alternatively, the plan may allow you to choose between the recalculation method and a term-certain method. The term-certain method bases annual payouts on your life expectancy or the joint life expectancy of you and your beneficiary as of the year in which you reach age 70½; this expectancy is reduced by one in each later year. Although the recalculation method generally allows you to spread out distributions over a longer period than the term-certain method, the term-certain method generally has advantages after the death of you or your beneficiary by requiring smaller minimum distributions for the survivor.

Basing payments on the joint life expectancies of yourself and a younger beneficiary will extend the withdrawal period, but the law imposes a limit if the beneficiary is someone other than your spouse. For example, a beneficiary more than 10 years younger than you will be treated as being only 10 years younger, regardless of actual age. This requirement does not affect payments required for spouses under the qualified joint and survivor annuity rule of ¶7.11. As discussed at ¶7.11, your plan must automatically provide annuity benefits in the form of a qualified joint and survivor annuity if you are married, unless you and your spouse elect otherwise.

Minimum distributions that you are required to take under these rules may not be rolled over tax free.

Important: The rules for determining minimum required distributions are complicated. Contact your employer's plan administrator well in advance to determine your options in selecting beneficiaries and figuring a payment schedule. Also, consult with your tax adviser about the choice between the term-certain method and the recalculation method if your plan allows you to make an election.

Penalty for Insufficient Distributions

If you are still working in the year you reach age 70½, set up a payment schedule with your employer's plan administrator. Otherwise, you will be subject to a 50% penalty if you fail to take a distribution from the plan by the required beginning date or you receive a distribution that is insufficient under the required distribution methods. Unless waived by the IRS, the 50% penalty will apply to the difference between the amount you should have received and the amount you did receive. The IRS may waive the penalty if you show that the shortfall was due to reasonable error and that you are taking steps to correct it. To apply for a waiver, compute the penalty on Form 5329 and attach a letter of explanation. Individuals who made a special election before 1984 to receive distributions under pre-1984 rules will not be subject to the penalty.

PAYOUTS TO BENEFICIARIES

The distribution rules for beneficiaries depend on whether the employee or self-employed plan participant dies before his or her "required beginning date." The required beginning date is April 1 of the year following the year in which the participant reached age 70½, or would have reached age 70½ had he or she lived. For example, for a plan participant reaching age 70½ in 1996, the required beginning date is April 1, 1997.

If an employee dies on or after required beginning date. Where an employee or self-employed individual dies on or after the required beginning date (April 1 of the year after the year in which age 70½ is reached), beneficiaries must continue to take distribu-

tions at least as rapidly as under the method being used by the plan participant during his or her lifetime. For example, if an employee had elected under the term-certain method to receive benefits over the 24-year joint life expectancy for himself and his beneficiary, but died after 10 years, the beneficiary would have to receive installments over the remaining 14 years but could elect to accelerate payments over a shorter period. Where the employee's life expectancy had been recalculated annually, the minimum required distributions to the beneficiary are based on his or her remaining single life expectancy; that is, the single life expectancy in the first distribution year reduced by one for each elapsed year.

A beneficiary who chooses a lump-sum distribution instead of installment payments may claim special averaging if the employee met the age test; *see* ¶7.7. A surviving spouse may also elect a tax-free rollover; *see* ¶7.8.

A surviving spouse receiving an annuity under the survivor benefit rules of ¶7.11 receives payments over his or her lifetime, starting at the participant's death.

If an employee dies before the required beginning date. If an employee or self-employed person dies before the April 1 required beginning date, distribution rules depend on who the beneficiary is and the terms of the plan. The plan may give the beneficiary the option of (1) taking distributions annually over his or her life expectancy, or (2) completing all distributions by the end of the fifth year following the year of the employee's death. On the other hand, the plan may specify which method must be used or place restrictions on use of the life expectancy method, such as limiting it to a specific term of years. If the plan does not specify the method and the beneficiary does not make an election by December 31 of the year following the year of death, the life expectancy method discussed below must be used by a surviving spouse; a beneficiary other than a surviving spouse must use the five-year method. For a lump-sum distribution, a beneficiary may use special averaging if the employee would have qualified; *see* ¶7.7. A surviving spouse may make a tax-free rollover of a lump sum; *see* ¶7.8.

Life expectancy method. If the plan gives the beneficiary the option of taking distributions over his or her life expectancy, the distribution starting date depends on who the beneficiary is:

A *surviving spouse* who is not receiving annuity payments under the rules of ¶7.11 may delay the start of distributions until the later of: (1) December 31 of the year in which the deceased spouse would have reached age 70½, and (2) December 31 of the year after the year of the employee's death. By that later date, the surviving spouse must take the first distribution based upon his or her life expectancy.

A *nonspouse beneficiary* has until December 31 of the year following the year of the employee's death to take the first distribution under his or her life expectancy. If he or she has the option to elect this life expectancy method but fails to do so by December 31 of the year following the year of the employee's death, the five-year method must be used.

Five-year method. Under this method, all distributions must be completed by December 31 of the fifth year following the year of the employee's death. For example, if an employee dies on January 6, 1996, the entire account must be distributed to the beneficiary by December 31, 2001, under the five-year method.

¶7.14 Penalty for Distributions Before Age 59½

A 10% penalty generally applies to taxable distributions received before you reach age 59½ from a qualified corporate or Keogh plan, qualified annuity plan, and tax-sheltered annuity plan, but there are several exceptions. For example, the penalty does not apply to distributions made to you after separation from service if the separation occurs during or after the year in which you reach age 55. A full list of exceptions is shown below.

If no exception applies, the penalty is 10% of the taxable distribution. If you make a tax-free rollover (¶7.8), the distribution is not taxable and not subject to the penalty. If a partial rollover is made, the part not rolled over is taxable and subject to the penalty. The 10% penalty must be figured on Form 5329, which is attached to your Form 1040.

A similar 10% penalty applies to IRA distributions before age 59½; *see* ¶8.12 for IRA penalty rules. The penalty for pre–age 59½ distributions from deferred annuities is at ¶7.22. The penalty does *not* apply to Section 457 plans of tax-exempt employers or state or local governments.

Exceptions to the penalty. The following distributions are exempt from the 10% penalty, even if received before age 59½. If your employer "knows" that an exception applies, a code for the exception will be entered in Box 7 of Form 1099-R on which the distribution is reported.

- Distributions that you roll over tax free under the "direct rollover" or "personal rollover" rules of ¶7.8.
- Distributions made on account of your total disability.
- Distributions after separation from service if you are age 55 or over in the year you retire or leave the company.
- Distributions used to pay deductible medical expenses exceeding 7.5% of adjusted gross income (whether or not an itemized deduction for medical expenses is claimed).
- Distributions received after separation from service which are part of a series of substantially equal payments (at least annually) over your life expectancy, or over the joint life expectancy of yourself and your designated beneficiary. If you claim the exception and begin to receive such a series of payments but then before age 59½ you receive a lump sum or change the distribution method and you are not totally disabled, a recapture penalty tax will apply. The recapture tax applies the 10% penalty to all amounts received before age 59½, as if the exception had never been allowed, plus interest for that period. The recapture tax also applies to payments received before age 59½ if substantially equal payments are not received for at least five years.
- Distributions paid to an alternate payee pursuant to a qualified domestic relations court order (QDRO).
- Distributions made pursuant to a designation under the 1982 Tax Act (TEFRA).
- Distributions to an employee who separated from service by March 1, 1986, provided that accrued benefits were in pay status as of that date under a written election specifying the payout schedule.

Corrective distributions from 401(k) plans. If you are considered a highly compensated employee and excess elective deferrals or excess contributions are made on your behalf, a distribution of the excess to you is not subject to the penalty.

Beneficiaries exempt from the penalty. If you are the beneficiary of a deceased plan participant, you are not subject to the 10% penalty, regardless of your age or the participant's age.

Filing Form 5329 for exceptions. If your employer correctly entered a penalty exception code in Box 7 of Form 1099-R, you do not have to file Form 5329 to claim the exception. You also do not have to file Form 5329 if you made a tax-free rollover of the entire taxable distribution. You must file Form 5329 if you qualify for an exception, other than the rollover exception, that is not indicated in Box 7 of Form 1099-R.

¶7.15 Penalty for Excess Distributions

You may be subject to a 15% penalty if during 1996 you withdrew amounts from an employer retirement plan or IRA *over* the following limits—

- $775,000 for lump sums qualifying for averaging; or
- $155,000 for IRA distributions *plus* all other types of distributions from qualified pension, profit-sharing, or stock bonus plans, annuity plans, or tax-sheltered annuities.

The 15% penalty is imposed on the excess amount. For example, in 1996, if you receive a $200,000 IRA distribution and the following exceptions do not apply, the penalty is $6,750 (15% × $45,000 excess).

The penalty is computed on Form 5329, which must be attached to your Form 1040. If an excess distribution is also subject to the penalty for premature withdrawals (¶7.14), the 15% excess distribution penalty is offset by the 10% premature withdrawal penalty; follow the Form 5329 instructions.

"Grandfather" election for benefit accruals as of August 1, 1986. If on your 1987 or 1988 return you made a special "grandfather" election (on Form 5329) for accrued benefits on August 1, 1986, exceeding $562,500, the penalty applies to 1996 distributions that exceed the *greater* of (1) the $155,000 or $775,000 threshold, and (2) the amount treated as a 1996 recovery of the "grandfathered" amount, as explained in the Form 5329 instructions.

Exceptions. The following amounts are not counted as distributions for purposes of the $155,000 or $775,000 limit and may help you avoid the penalty:

- Distributions equal to your after-tax contributions to a plan or your investment in the contract, including nondeductible IRA contributions;
- Distributions from a qualified plan which you roll over tax free to an IRA or to another qualified plan, or IRA distributions which are rolled over tax free to another IRA;
- Distributions to a former spouse pursuant to a qualified domestic relations order. The former spouse takes the distributions into account in determining whether the penalty applies;
- Distributions received by a deceased individual's beneficiary. However, the deceased person's federal estate tax liability is increased by 15% of his or her "excess retirement accumulation"; *see* the instructions to Schedule S of Form 706 for details;
- Distribution of excess salary reduction deferrals; and
- Distributions of excess contributions made to satisfy nondiscrimination rules.

LAW ALERT

Penalty Suspended After 1996

A new law suspends the 15% excess distribution penalty for three years: 1997, 1998, and 1999. In the year 2000, the penalty will be reinstated. The estate tax increase for excess retirement accumulations is not affected.

¶7.16 Restrictions on Loans From Company Plans

Within limits, you may receive a loan from a qualified company plan, annuity plan, or government plan without triggering tax consequences. The maximum loan you can receive without tax is the lesser of 50% of your vested account balance, and $50,000, but the $50,000 limit is subject to reductions where there are other loans outstanding; *see* below. Loans must be repaid within five years, unless they are used for buying your principal residence. Loans that do not meet these guidelines are treated as taxable distributions from the plan.

These rules generally apply only to employees. For a self-employed person, a retirement plan loan is a prohibited transaction that usually results in penalties; *see* ¶41.9.

If your vested accrued benefit is $20,000 or less, you are not taxed if the loan, when added to other outstanding loans from all plans of the employer, is $10,000 or less. However, as a practical matter, your maximum loan may not exceed 50% of your vested account balance because of a rule that only allows up to 50% of the vested balance to be used as loan security. Loans in excess of the 50% cap are allowed only if additional collateral is provided.

If your vested accrued benefit exceeds $20,000, then the maximum tax-free loan depends on whether you borrowed from any employer plan within the one-year period ending on the day before the date of the new loan. If you did not borrow within the year, you are not taxed on a loan that does not exceed the lesser of $50,000 and 50% of the vested benefit.

If there were loans within the one-year period, the $50,000 limit must be further reduced. The loan, when added to the outstanding loan balance, may not exceed $50,000 less the excess of (1) the highest outstanding loan balance during the one-year period (ending

the day before the new loan), over (2) the outstanding balance on the date of the new loan. This reduced $50,000 limit applies where it is less than 50% of the vested benefit; if 50% of the vested benefit was the smaller amount, that would be the maximum tax-free loan.

EXAMPLE

Your vested plan benefit is $200,000. Assume that in January 1997 you borrow $30,000 from the plan. On November 1, 1997, when the outstanding balance on the first loan is $20,000, you want to take another loan without incurring tax. You may borrow an additional $20,000 without incurring tax: The $50,000 limit is first reduced by the outstanding loan balance of $20,000—leaving $30,000. The reduced $30,000 limit is in turn reduced by $10,000, the excess of $30,000 (the highest loan balance within one year of the new loan) over $20,000 (the loan balance as of November 1).

The $20,000 loan limit applies because it is less than 50% of the vested benefit of $200,000.

Repayment period. Generally, loans within the previously discussed limits must be repaid within five years to avoid being treated as a taxable distribution. However, if you use the loan to purchase a principal residence for yourself, the repayment period may be longer than five years; any reasonable period is allowed. This exception does not apply if the plan loan is used to improve your existing principal residence, to buy a second home, or to finance the purchase of a home or home improvements for other family members; such loans are subject to the five-year repayment rule.

Level loan amortization required. To avoid tax consequences on a plan loan, you must be required to repay using a level amortization schedule, with payments at least quarterly. According to Congressional committee reports, you may accelerate repayment, and the employer may use a variable interest rate and require full repayment if you leave the company.

Giving a demand note does not satisfy the repayment requirements.The IRS and Tax Court held the entire amount of an employee's loan to be a taxable distribution since his demand loan did not require level amortization of principal and interest with at least quarterly payments. It did not matter that the employee had paid interest quarterly and actually repaid the loan within five years.

If required installments are not made, the entire loan balance must be treated as a "deemed distribution" from the plan under IRS proposed regulations. However, the IRS allows the plan administrator to permit a grace period of up to one calendar quarter. If the missed installment is not paid by the end of the grace period, there is at that time a deemed distribution in the amount of the outstanding loan balance.

Under IRS proposed regulations, loan repayments may be suspended for up to one year if the borrower takes a leave of absence during which he or she is paid less than the installments due. However, the installments after the leave must at least equal the original required amount and the loan must be repaid by the end of the allowable repayment period (five years if not used to buy a principal residence). For example, when his vested account balance is $80,000, Joe takes out a $40,000 nonprincipal residence loan on July 1, 1996 to be repaid in level monthly installments of $825 over five years. He makes nine payments and then takes a year unpaid leave. When he returns to work he can either increase his monthly payment to $1,130 or resume paying $825 a month and on June 30, 2001 repay the entire balance owed in a lump sum.

Spousal consent generally required to get a loan. All plans subject to the joint and survivor rules of ¶7.11 must require spousal consent in order to be able to use your account balance as security for the loan in case you default. Check with your plan administrator for consent requirements.

Interest deduction limitations. If you want to borrow from your account to buy a first or second residence, and you are not a "key" employee (¶3.3), you can obtain a full interest deduction by using the residence as collateral for the loan. Your account balance may not be used to secure the loan. Key employees are not allowed any interest deduction for plan loans.

If you use a plan loan for investment purposes and are not a key employee, and the loan is not secured by your elective deferrals (or allocable income) to a 401(k) plan or tax-sheltered annuity, the loan account interest is deductible up to investment income; *see* ¶15.10. Interest on loans used for personal purposes is not deductible, unless your residence is the security for the loan.

CAUTION

Unpaid Loan Taxable If You Leave Job

If you leave your company before your loan is paid off, the company will reduce your vested account balance by the outstanding debt. For example, if your vested account balance is $100,000, and the outstanding loan is $20,000, your account balance is reduced to $80,000, which your company pays you in a lump sum. However, according to the IRS, you are treated as if you received the entire $100,000. If you do not roll over (¶7.8) the entire $100,000, you will be taxed on the portion not rolled over, and possibly be subject to the 10% penalty for pre–age 59½ withdrawals; *see* ¶7.14. To avoid tax on the $20,000, you would have to use other resources or borrow funds in order to complete a total rollover within the 60-day period. If making a rollover to a new employer's plan, it might be possible to get an immediate $20,000 loan from the new plan, which could be put right back into the plan to complete the rollover.

401(k), 403(b), and Government Tax-Deferred Savings Plans

	See ¶
Tax benefits of 401(k) plans	7.17
Limit on salary reduction deferrals	7.18
Withdrawals from 401(k) plans restricted	7.19
Annuities for employees of tax-exempts and schools (403(b) plans)	7.20
Deferred pay plans for government employees	7.21

¶7.17 Tax Benefits of 401(k) Plans

If your company has a profit-sharing or stock bonus plan, it has the opportunity of giving you additional tax-sheltered pay. The tax law allows the company to add a cash or deferred pay plan, called a 401(k) plan, which can operate in one of two ways:

1. Your employer contributes an amount for your benefit to a trust account. You are not taxed on your employer's contribution.
2. You agree to take a salary reduction or to forego a salary increase. The reduction is placed in a trust account for your benefit. The reduction is not considered taxable pay because it is treated as your employer's contribution. In addition, your company may match part of your contribution. For 1996, the law limits salary reduction deferrals to $9,500; *see* ¶7.18. The limit is subject to annual inflation adjustments.

Starting in 1997, salary reduction deferrals may be limited to $6,000 if the employer adopts a new type of 401(k) plan–a "SIMPLE" 401(k); *see* the Law Alert in the next column.

Making salary deferrals may be an ideal way to defer income and get a tax-free buildup of earnings. Although there is no income tax, the contribution is subject to Social Security tax.

Income earned on the trust account accumulates tax free until it is withdrawn. Withdrawals before age 59½ are restricted, as explained in ¶7.19.

A lump-sum distribution may be eligible for special averaging under the rules of ¶7.4. Lump-sum distributions exceeding $775,000 in 1996 may be subject to the excess distribution penalty; *see* ¶7.15.

Mandatory 20% withholding applies to distributions, including lump sums, that are eligible for tax-free rollover; *see* ¶7.8.

An employer may not require you to make elective deferrals in order to obtain any other benefits, apart from matching contributions. For example, benefits provided under health plans or other compensation plans may not be conditioned on your making salary deferrals to a 401(k) plan.

Nondiscrimination rules. The law imposes strict contribution percentage tests to prevent discrimination in favor of employees who are highly compensated. If these tests are violated, the employer is subject to penalties and the plan could be disqualified unless the excess contributions (plus allocable income) are distributed back to the highly compensated employees within specified time limits.

Nondiscrimination tests are eased for employers who after 1996 contribute to a "SIMPLE" plan; *see* the Law Alert below.

Partnership plans. Partnership plans that allow partners to vary annual contributions are treated as 401(k) plans by the IRS. Thus, elective deferrals are subject to the annual limit (¶7.18) and the special 401(k) plan nondiscrimination rules apply. However, partnerships may allow new incoming partners to make a one-time irrevocable election to contribute a specified amount or percentage of compensation to the partnership plan for the entire period they are with the partnership. Contributions pursuant to the one-time election are not treated as part of a 401(k) plan.

LAW ALERT

SIMPLE 401(k) Plans Starting in 1997

After 1996, an employer that does not maintain another qualified plan is deemed to satisfy 401(k) plan nondiscrimination requirements if employee elective deferrals are limited to $6,000 and the employer either matches the first 3% of compensation deferred to the plan or contributes 2% of compensation for all eligible employees with at least $5,000 in compensation. All contributions must be 100% vested.

¶7.18 Limit on Salary Reduction Deferrals

The law limits the maximum tax-free salary reduction contribution you can make. For 1996, the limit is $9,500. The $9,500 limit may be increased after 1996 by an inflation factor. Employer plans must limit elective deferrals to the annual tax-free ceiling; otherwise, the plan could be disqualified. Certain highly compensated employees may be unable to take advantage of the maximum tax-free ceiling ($9,500 in 1996) because of restrictions imposed by nondiscrimination tests; *see* the Caution at the end of this section.

To avoid the strict nondiscrimination tests for employee elective deferrals and employer matching contributions, an employer may make contributions after 1996 to a SIMPLE 401(k); *see* the Law Alert in ¶7.17.

$9,500 limit for 1996. The $9,500 limit applies to total salary reduction deferrals made to 401(k) plans as well as to 403(b) tax-sheltered annuity plans (¶7.20) and simplified employee pension plans (¶8.16). If you participate in more than one such plan, the $9,500 limit applies to the total salary reductions for all the plans.

The $9,500 tax-free limit applies only to an employee's elective deferrals from pay. An employer may make matching or other additional contributions, provided the total contribution, including the employee's salary deferral, does not exceed the lesser of 25% of compensation and $30,000.

If you make salary deferrals to more than one plan and the total exceeds the annual limit, the excess deferrals are taxable in the year of the deferral. Furthermore, if the excess contribution (*plus* income earned on such excess) is not distributed to you by the first April 15 following the year of the excess deferral, it is taxed again when distributed from the plan. Excess deferrals (and earnings) distributed by the April 15 deadline are not subject to the 10% penalty for premature distributions (¶7.14) even if you are under age 59½.

Exception for one-time elections. The annual ceiling on salary deferrals does not apply if at the time you become eligible to participate in the plan you make a one-time irrevocable election to have a specified percentage of your pay contributed to the plan for as long as you are employed.

CAUTION

Reduced Deferral Limit for Highly Compensated Employees

To avoid discrimination problems an employer may set a lower limit for elective salary deferrals by highly compensated employees than the ceiling generally allowed ($9,500 for 1996).

If, after contributions are made, the plan fails to meet the nondiscrimination tests, the excess contributions will either be returned to the highly compensated employees or kept in the plan but recharacterized as after-tax contributions. In either case, the excess contribution is taxable. Form 1099-R will indicate the excess contribution.

For years after 1996, employers may avoid the nondiscrimination tests by meeting the SIMPLE plan contribution rules; *see* the Law Alert in ¶7.17.

¶7.19 Withdrawals From 401(k) Plans Restricted

By law, you may not withdraw funds attributable to elective salary reduction contributions until you reach age 59½, are separated from service, become totally disabled, or show financial hardship. Under IRS rules, it is difficult to qualify for hardship withdrawals; *see* below. Lump-sum withdrawals are also allowed if the plan terminates, or the corporation sells its assets or its interest in a subsidiary and you continue to work for the buyer or the subsidiary. However, the hardship provision and age 59½ withdrawal allowance do not apply to certain "pre-ERISA" money purchase pension plans (in existence June 27, 1974).

Withdrawals before age 59½. Withdrawals for medical disability, financial hardship, or separation from service are subject to the 10% penalty for premature withdrawals unless you meet one of the exceptions listed at ¶7.14.

Loans. If you are allowed to borrow from the plan, the loan restrictions at ¶7.16 apply.

Qualifying for hardship withdrawals. IRS regulations restrict hardship withdrawals. If you qualify under the following restrictive rules you may withdraw only your elective deferrals *plus* a limited amount of income. Income allocable to elective deferrals may be withdrawn only if it was credited to your account as of the end of the last plan year ending before July 1, 1989; the plan may provide an even earlier cutoff date for income. Employer matching contributions, non-elective contributions, and other plan earnings may not be included.

The IRS requires you to show an immediate and heavy financial need that cannot be met with other resources.

Financial need includes the following expenses (this list may be expanded by the IRS in rulings):

- Purchase of a principal residence for yourself (but not mortgage payments);
- Tuition, related fees and room and board for the next 12 months of post-secondary education for yourself, your spouse, children, or other dependents;
- Medical expenses previously incurred for yourself, your spouse or dependents, or expenses incurred to obtain medical care for such persons;
- Preventing your eviction or mortgage foreclosure; and
- Paying funeral expenses for a family member.

Even if you can show financial need, you may not make a hardship withdrawal if you have other resources to pay the expenses. You do not have to provide your employer with a detailed financial statement, but you must state to your employer that you cannot pay the expenses with: compensation, insurance, or reimbursements; liquidation of your assets without causing yourself hardship by virtue of the liquidation; stopping your contributions, including salary deferrals, to the plan; other distributions or nontaxable loans from plans of any employer; or borrowing from a commercial lender. Your spouse's assets, as well as those of your minor children, are considered to be yours unless you show that they are not available to you. For example, property held in trust for a child or under the Uniform Gifts to Minors Act is not treated as your property.

Under a special rule, you are considered to lack other resources if you have taken all available distributions from all plans of the employer, including nontaxable loans, and you suspend making any contributions to any of the employer's qualified and nonqualified deferred compensation plans for at least 12 months after receipt of the hardship distribution. Furthermore, all of the employer's plans must provide that for the year after the year of the hardship distribution, elective contributions must be limited to the excess of the annual salary deferral limitation over the elective contributions made for the year of the hardship distribution.

¶7.20 Annuities for Employees of Tax-Exempts and Schools (403(b) Plans)

If you are employed by a state or local government public school, or by a tax-exempt religious, charitable, scientific, or educational organization, or are on the civilian staff or faculty of the Uniformed Services University of the Health Sciences (Department of Defense), you may be able to arrange for the purchase of a nonforfeitable tax-sheltered annuity. Another name for such a tax-sheltered annuity is a 403(b) plan. 403(b)plan may be funded in mutual-fund shares.

The purchase of the annuity is generally made through a reduction of salary which is used to pay for the contract. The amount of the salary reduction used to buy the contract is not taxable if it comes within specified limits. The tax rules for computing the exclusion are complicated, as there are several limitations and exceptions.

Note: As the following contribution rules for tax-sheltered annuities have been stated in general terms and are subject to Treasury regulations, we suggest that you also consult your employer or the issuer of the contract. IRS Publication 571 has detailed examples.

Tax-free exclusion allowance. The tax-sheltered contribution, called the exclusion allowance, is generally 20% of your pay multiplied by the number of years of service with your employer less tax-free contributions made in prior years by your employer to a tax-sheltered annuity or to any qualified plan: Salary reductions count as tax-free employer contributions. Under this formula, you may not be allowed to exclude any part of the current year's salary reduction because of employer contributions in prior years. Further, even though allowed by the 20% of *pay/years* of service formula, the maximum tax-free salary reduction may not exceed the lower of 25% of your pay and the annual ceiling on elective deferrals, which for 1996 is $9,500. However, employees with at least 15 years of service may be able to defer an additional $3,000 each year. *See* the next column for details of the $9,500 limit and the exceptions.

EXAMPLE

Carol Grossinger, a public school teacher earning $30,000, agrees to a $2,400 salary reduction to be used to purchase an annuity contract. The employer also contributes $1,800 per year to a pension trust for the teacher's account. In the first year, the entire salary reduction contribution is tax free as it is within the $5,520 exclusion allowance (20% of the reduced salary of $27,600 × one year service). In later years, part or all of the reduction may be taxed because the exclusion allowance is reduced by prior tax-free employer contributions.

Alternative contribution ceilings. Subject to the maximum salary reduction limit ($9,500 for 1996), employees of schools, hospitals, churches, health and welfare service agencies, and home health service agencies may be able to elect tax-free contributions that exceed 25% of pay, or that exceed the exclusion allowance. There are three alternative methods, but only one may be elected and an election is irrevocable.

One alternative allows such employees to irrevocably elect a limitation equal to the *lower* of (1) the general 20% of pay exclusion allowance, (2) 25% of pay plus $4,000, and (3) $15,000. Another alternative election allows such employees to make an irrevocable election to disregard the general 20% exclusion allowance. If the election is made, the tax-free contribution equals the contribution limit for defined contribution plans, the *lesser* of 25% of pay and $30,000.

The third alternative allows such employees in the year of separation from service to elect a tax-free contribution limit equal to the *lower* of (1) $30,000, (2) the exclusion allowance, taking into account no more than 10 years of service, and (3) the annual limit on salary-reduction deferrals, which is $9,500 for 1996. This limit may be used only once.

Church employees. A church employee whose adjusted gross income is $17,000 or less is allowed a minimum exclusion allowance equal to the *lesser* of $3,000 and his or her includable compensation. In addition, an election may be made permitting contributions exceeding the 25% of pay test, up to $10,000 per year; however, there is a lifetime contribution limit of $40,000.

$9,500 salary deferral limit for 1996. Even if allowed by the general exclusion allowance rule, the maximum tax-free salary reduction from a tax-sheltered annuity plan for 1996 cannot exceed the *lower* of $9,500 and 25% of pay. If you work for more than one employer, the $9,500 limit applies to all tax-sheltered annuity arrangements in which you participate. An increased limit for certain employees with 15 years of service is discussed on page 142.

The $9,500 salary-reduction limit may be increased after 1996 by an inflation factor.

Your contributions are not considered salary reductions, and, therefore, are not subject to the annual limit for salary-reduction deferrals ($9,500 in 1996) if they are made under a one-time irrevocable election at the time you became eligible to participate in the plan.

If, in addition to a tax-sheltered annuity, you make salary deferrals to a 401(k) plan or simplified employee pension plan, the annual salary reduction limit applies to the total deferrals; *see* ¶7.18. If you defer more than the annual limit, the excess is taxable. Further, if a salary reduction deferral in excess of the annual limit is made and the excess is not distributed to you by April 15 of the following year, the excess will be taxed twice—not only in the year of deferral but again in the year it is actually distributed. To avoid the double tax, any excess deferral plus the income attributable to such excess

should be distributed no later than April 15 of the year following the year in which the excess deferral is made. A distribution by the following April 15 is not subject to the premature withdrawal penalty (¶7.14) or the penalty for excess distributions (¶7.15). A distribution of the excess deferral is taxed in the year for which the deferral was made; distributed income is taxed in the year received.

If your employer makes separate contributions in addition to your salary-reduction deferrals, the total of elective salary reductions (not to exceed the annual limit) plus the employer contributions may be up to the contribution limit for defined contribution plans, which is generally the lower of 25% of pay and $30,000; the $30,000 ceiling may be increased after 1996.

Special catch-up election for certain employees with 15 years of service. If allowed under the general 20% of *pay/years* of service exclusion formula, and by the 25% of pay limit, the annual salary reduction ceiling ($9,500 for 1996) is increased by $3,000 for employees of educational organizations, hospitals, churches, home health service agencies, and health and welfare service agencies who have completed 15 years of service. However, the extra $3,000 annual deferral may not be claimed indefinitely. There is a lifetime limit of $15,000 on the amount of extra deferrals allowed. Furthermore, the extra deferrals may not be claimed after lifetime elective deferrals to the plan exceed $5,000 multiplied by your years of service.

Distributions from tax-sheltered annuities. Distributions from a tax-sheltered annuity do not qualify for special averaging (¶7.4), but a tax-free rollover of a distribution may be made to another tax-sheltered annuity or IRA. If you do not choose to have the payer of the distribution make a direct rollover, mandatory 20% withholding will be applied. You may then personally make a rollover within 60 days, but you would have to include the withheld amount in the rolled-over amount to avoid tax on the entire distribution. *See* ¶7.8 for further rollover and withholding details.

Annuity payments are taxed under the general rules for employee annuities, discussed at ¶7.25. The payments are subject to the $150,000 limit for purposes of the excess distribution penalty; *see* ¶7.15. Further, benefits accruing after 1986 are subject to the age 70½ required beginning date rules of ¶7.13 and a penalty may be imposed for failure to take minimum required distributions.

To change tax-sheltered annuity investments, you may direct the issuer of your current annuity contract to make a direct transfer of your account to a different issuer. The transfer is tax free, provided that distributions with respect to salary reduction contributions are restricted under both contracts. Generally, such distributions are allowed only when the employee reaches age 59½, separates from service, becomes disabled, suffers financial hardship, or dies.

¶7.21 Deferred Pay Plans for Government Employees

Federal government employees may make tax-free salary-reduction contributions to the Federal Thrift Savings Fund. Employees of state and local governments and of tax-exempt organizations may be able to make tax-free salary-reduction contributions to a Section 457 deferred compensation plan.

Federal employees. Federal employees may elect to defer up to 10% of their basic pay to the Federal Thrift Savings Fund, but no more than the limit on elective deferrals. The deferral limit for 1996 is $9,500, the same as for 401(k) plans; *see* ¶7.18. The limit is subject to increases for inflation. Deferrals are not taxed until distributed from the plan. The deferred amount is counted as wages for purposes of computing Social Security taxes and benefits.

Distributions from the Thrift Savings Fund are generally fully taxable. However, lump-sum distributions are eligible for special averaging under the rules of ¶7.4, or tax-free rollover treatment; *see* ¶7.8. If you separate from service before the year in which you reach age 55, you are subject to the 10% penalty for premature distributions unless you are disabled or qualify for the medical exception discussed at ¶7.14.

Section 457 state and local government plans. State and local governments may set up deferred compensation plans which allow employees to defer annually up to the *lesser* of $7,500 and 33⅓% of includible compensation (not including the deferrals). Under a new law, the $7,500 limit is subject to inflation increases starting in 1997.

A limited "catch-up" provision allows employees in the last three years before reaching normal retirement age to defer larger amounts, provided that the full $7,500 or 33⅓% limit has not been used in prior years. The catch-up deferral, figured under IRS regulations, may not exceed $15,000. Deferred pay and income allocable to the deferrals is not taxed until the year it is distributed or made available to the employee. Distributions are fully taxable; averaging and rollover treatment may not be claimed.

The annual deferral limit does not apply to vacation leave, sick leave, disability pay, compensatory time, severance pay, or death benefits plans.

If an employee participates in more than one Section 457 plan, the annual limit applies to total deferrals under all the plans. Furthermore, if an employee also participates in a tax-sheltered annuity plan, simplified employee pension (SEP), 401(k) plan, or Section 501(c)(18) plan (created before June 25, 1959, and funded solely by employee contributions), the annual Section 457 plan limit is reduced by tax-free deferrals to the other plan.

Distributions to employees or beneficiaries generally may not be made before the year the employee turns age 70½, the employee separates from service, or faces an "unforeseeable" emergency, assuming the plan allows payment in cases of emergency. Under IRS regulations, an unforeseeable emergency generally means severe financial hardship resulting from a sudden illness or accident of the employee or a dependent, or loss of property due to a casualty. If the employee can obtain funds by ceasing deferrals to the plan or by liquidating assets without causing himself or herself severe financial hardship, payment from the plan is not allowed. The regulations specifically prohibit payments from the plan to purchase a home or pay for a child's college tuition.

After 1996, a one-time in-service distribution may be made if the account balance is $3,500 or less and there have been no plan deferrals in the prior two-year period.

See ¶7.13 for required distribution starting dates after age 70½ and minimum payout rules. Where an employee dies before receiving distributions, the account balance must be paid to non-spouse beneficiaries over a period of 15 years or less. Payments to a surviving spouse may be made over the spouse's life expectancy.

Note: Check with your employer for other details on Section 457 contributions and distribution rules.

Tax-exempt organizations eligible. Section 457 plans may also be set up by nongovernmental tax-exempt organizations other than churches.

Reporting Commercial Annuities

	See ¶
Figuring the taxable part of your annuity	7.22
Life expectancy tables	7.23
When you convert your endowment policy	7.24

¶7.22 Figuring the Taxable Part of Your Annuity

Tax treatment of a distribution depends on whether you receive it before or after the annuity starting date, and on the amount of your investment. A cash withdrawal before age 59½ from an annuity contract is generally subject to a 10% penalty but there are exceptions; the penalty is discussed at the end of this section. If your annuity is from an employer plan and it started after July 1, 1986, *see* ¶7.25.

Payments before the annuity starting date. If your commercial annuity contract was purchased after August 13, 1982, withdrawals before the annuity starting date are taxable to the extent that the cash value of the contract, immediately before the distribution, exceeds your investment in the contract. This rule also applies to withdrawals that are attributed to investments made after August 13, 1982, where the contract was purchased before August 14, 1982. Loans under the contract or pledges are treated as cash withdrawals. Withdrawals from contracts bought by a qualified retirement plan are discussed at ¶7.25.

The *annuity starting date* is the first day of the first period for which you receive a payment. If your monthly payments start on August 1 for the period starting July 1, July 1 is your annuity starting date.

If the contract was purchased before August 14, 1982, withdrawals before the annuity starting date are taxable only if they exceed your investment. Loans are tax free and are not treated as withdrawals subject to this rule. Where additional investments were made after August 13, 1982, cash withdrawals are first considered to be tax-free distributions of the investment before August 14, 1982. If the withdrawal exceeds this investment, the balance is fully taxable to the extent of earnings on the contract, with any excess withdrawals treated as a tax-free recovery of the investment made after August 14, 1982.

Payments on or after the annuity starting date. If the withdrawal is a regular annuity payment, that part of the annuity payment allocated to your cost investment is treated as a nontaxable return of the cost; the balance is taxable income earned on the investment. You may find the taxable part of your annuity payment by following the six steps listed below under "Taxable Portion of Annuity Payments." If you have a variable annuity, the computation of the tax-free portion is discussed following Step 6.

Payments on or after the annuity starting date that are not part of the annuity, such as dividends, are generally taxable, but there are exceptions. If the contract is a life insurance or endowment contract, withdrawals of earnings are tax free to the extent of your investment, unless the contract is a modified endowment contract discussed at ¶33.9.

Payments on a complete surrender of the contract or at maturity are taxable only to the extent they exceed your investment.

TAXABLE PORTION OF ANNUITY PAYMENTS

If the payer of the contract does not provide the taxable amount in Box 2a of Form 1099-R, you can compute the taxable amount of your commercial annuity using the following steps.

If you have an employee annuity (¶7.25) that started before July 2, 1986, you also can use the following six steps to figure your taxable payment. If your employee annuity started after July 1, 1986, you may use a simplified method discussed at ¶7.25 and ¶7.26.

Step 1. Figure your investment in the annuity contract. If you have no investment in the contract, annuity income is fully taxable; therefore, ignore Steps 2 through 6.

If your annuity is—	*Your cost is—*
Single premium annuity contract	The single premium paid.
Deferred annuity contract	The total premiums paid.
A gift	Your donor's cost.
An employee annuity	The total of your after-tax contributions to the plan *plus* your employer's contributions which you were required to report as income; *see* ¶7.25.
With a refund feature	The value of the refund feature.

From cost, you subtract the following items:

- Any premiums refunded, and rebates or dividends received on or before the annuity starting date.
- Additional premiums for double indemnity or disability benefits.
- Amounts received under the contract before the annuity starting date to the extent these amounts were not taxed; *see* the previous page.
- Value of a refund feature; *see* below.

Value of refund feature. Your investment in the contract is reduced by the value, if any, of the refund feature.

Your annuity has a refund feature when these three requirements are present: (1) The refund under the contract depends, even in part, on the life expectancy of at least one person; (2) the contract provides for payments to a beneficiary or the annuitant's estate after the annuitant's death; and (3) the payments to the estate or beneficiary are a refund of the amount paid for the annuity.

The value of the refund feature is figured by using a life expectancy multiple which may be found in Treasury Table III or Table VII depending on the date of your investment; the tables are in IRS Publication 939.

Where an employer paid part of the cost, the refund is figured on only the part paid by the employee.

The refund feature is considered to be *zero* if (1) for a joint and survivor annuity, both annuitants are age 74 or younger, the payments are guaranteed for less than 2½ years, and the survivor's annuity is at least 50% of the first annuitant's (retiree's) annuity; or (2) for a single-life annuity without survivor benefits, the payments are guaranteed for less than 2½ years and you are age 57 or younger if using the new (unisex) annuity tables, age 42 or younger if male and using the old annuity tables, or age 47 or younger if female and using the old annuity tables.

Also subtract from cost any tax-free recovery of your investment received *before* the annuity starting date, as previously discussed.

Step 2. Find your expected return. This is the total of all the payments you are to receive. If the payments are to be made to you for life, your expected return is figured by multiplying the amount of the annual payment by your life expectancy as of the nearest birthday to the annuity starting date. The annuity starting date is the first day of the first period for which an annuity payment is received. For example, on January 1 you complete payment under an annuity contract providing for monthly payments starting on July 1 for the period beginning June 1. The annuity starting date is June 1. Use that date in computing your investment in the contract under Step 1 and your expected return.

If payments are for life, you find your life expectancy in IRS tables included in IRS Publication 939. The table for single life annuities is in ¶7.23. When using the table, your age is the age at the birthday nearest the annuity starting date. If you have a joint and survivor annuity and after your death the same payments are to be made to a second annuitant, the expected return is based on your joint life expectancy. Use Treasury Table II in IRS Publication 939 to get joint life expectancy if the entire investment was before July 1, 1986. Use Treasury Table VI if any investment was made after June 30, 1986. If your joint and survivor annuity provides for a different payment amount to the survivor, you must separately compute the expected return for each annuitant; this method is explained in Publication 939. Adjustments to the life expectancy multiple are required when your annuity is payable quarterly, semiannually, or annually. The required adjustment is discussed in ¶7.23.

If the payments are for a fixed number of years or for life, whichever is shorter, find your expected return by multiplying your annual payments by a life expectancy multiple found in Treasury Table IV if your entire investment was before July 1, 1986, or Table VIII if any investment was made after June 30, 1986.

If payments are for a fixed number of years (as in an endowment contract) without regard to your life expectancy, find your expected return by multiplying your annual payment by the number of years.

Note: *See* ¶7.23 for more information on the life expectancy tables.

Step 3. Divide the investment in the contract (Step 1) by the expected return (Step 2). This will give you the tax-free percentage of your yearly annuity payments. The tax-free percentage remains the same for the remaining years of the annuity, even if payments increase due to a cost-of-living adjustment. A different computation of the tax-free percentage applies to variable annuities; *see* below.

If your annuity started before 1987, and you live longer than your projected life expectancy (shown in the IRS table), you may continue to apply the same tax-free percentage to each payment you receive. Thus, you may exclude from income more than you paid. However, if your annuity starting date is after 1986, your lifetime exclusion may not exceed your cost investment, less the value of any refund feature. Once you have recovered your cost, further payments are fully taxable.

If your annuity starting date is after July 1, 1986, and you die before recovering your investment, a deduction is allowed on your final tax return for the unrecovered cost. If a refund of the investment is made under the contract to a beneficiary, the beneficiary is allowed the deduction. The deduction is claimed as a miscellaneous itemized deduction that is not subject to the 2% adjusted gross income floor; *see* Chapter 19.

Step 4. Find your total annuity payments for the year. For example, you received 10 monthly payments of $100 as your annuity began in March. Your total payments are $1,000, the monthly payment multiplied by 10.

Step 5. Multiply the percentage in Step 3 by the total in Step 4. The result is the nontaxable portion (or excludable amount) of your annuity payments.

Step 6. Subtract the amount in Step 5 from the amount in Step 4. This is the part of your annuity for the year which is subject to tax.

Note: An example of figuring the taxable and nontaxable portions for a single life annuity is in ¶7.23.

Variable annuities. If you have a variable annuity that pays different benefits depending on cost-of-living indexes, profits earned by the annuity fund, or similar fluctuating standards, the tax-free portion of each payment is computed by dividing your investment in the contract (Step 1) by the total number of payments you expect to receive. If the annuity is for a definite period, the total number of payments equals the number of payments to be made each year mul-

tiplied by the number of years you will receive payments. If the annuity is for life, you divide the amount you invested in the contract by a multiple obtained from the appropriate life expectancy table; *see* Step 2. The result is the tax-free amount of annual annuity income.

If you receive a payment which is *less* than the nontaxable amount, you may elect when you receive the next payment to recalculate the nontaxable portion. The amount by which the prior nontaxable portion exceeded the payment you received is divided by the number of payments you expect as of the time of the next payment. The result is added to the previously calculated nontaxable portion, and the sum is the amount of each future payment to be excluded from tax. A statement must be attached to your return explaining the recomputation.

EXAMPLES

1. Andrew Taylor's total investment of $12,000 for a variable annuity was made after June 30, 1986. The annuity starting date is January 1, 1996. The annuity will be paid starting July 1, 1996, in varying annual installments for life. Andrew's age (nearest birthday) at the January 1 starting date is 65. He uses a life expectancy multiple of 20.0, the amount shown in Table V on page 147 for a male age 65. The amount of each payment excluded from tax is:

Investment in the contract	$12,000
Multiple (from Table V)	20.0
Amount of each payment excluded from tax ($12,000 ÷ 20)	$600

If the first payment is $920, then 320 ($920 – $600) will be included in Andrew's 1997 income.

2. Assume that, after receiving the 1999 payment of $920 in Example 1, Andrew receives $500 in 1999 and $1,200 in 1999. None of the 1999 payment is taxed, as $600 is excludable from each annual payment. Andrew may also elect to recompute his annual exclusion starting with the 1999 payment. The exclusion is recomputed as follows:

Amount excludable in 1999	$600
Amount received in 1999	500
Difference	$100
Multiple as of 1/1/99 (*see* Table V on page 146 for age 67)	18.4
Amount added to previously determined annual exclusion ($100 ÷ 18.4)	$5.43
Revised annual exclusion for 1999 and later years ($600 + $5.43)	$605.43
Amount taxable in 1999 ($1,200 – $605.43)	$594.57

PENALTY ON PREMATURE WITHDRAWALS FROM DEFERRED ANNUITIES.

As discussed on page 143, withdrawals before the annuity starting date may be taxable or tax free, depending on whether investments were made after August 13, 1982.

Withdrawals before age 59½ are also generally subject to a penalty of 10% of the amount includable in income. A withdrawal in 1996 from an annuity contract is penalized unless:

1. You have reached age 59½ or have become totally disabled.
2. The distribution is part of a series of substantially equal payments, made at least annually over your life expectancy or over the joint life expectancies of you and a beneficiary. If you can avoid the penalty under this exception and you change to a nonqualifying distribution method within five years or before age 59½, such as where you receive a lump sum, a recapture tax will apply to the payments received before age 59½.
3. The payment is received by a beneficiary or estate after the policyholder's death.
4. Payment is from a qualified retirement plan, tax-sheltered annuity, or IRA; in this case the penalty rules of ¶7.14 (qualified plans) or ¶8.8 (IRAs) apply.
5. Payment is allocable to investments made before August 14, 1982.
6. Payment is from an annuity contract under a qualified personal injury settlement.
7. Payment is from a single-premium annuity where the starting date is no more than one year from the date of purchase.
8. Payment is from an annuity purchased by an employer upon the termination of a qualified retirement plan and held until you separated from service.

If no exception applies, you compute the 10% penalty on Form 5329. The penalty is 5% instead of 10% if as of March 1, 1986, you were receiving payments under a specific schedule pursuant to your written election. Attach an explanation to Form 5329 if you are applying the 5% rate.

¶7.23 Life Expectancy Tables

IRS unisex actuarial tables must be used if you made any investment in the annuity contract after June 30, 1986. Generally, life expectancies are longer under the unisex tables than under the prior male–female tables. The unisex life expectancy table for single life annuities is IRS Table V, shown on page 147. A sample of the unisex table for ordinary joint life and last survivor annuities is at the end of Chapter 8. The full table is Table VI, in IRS Publication 939.

If your entire investment was before July 1, 1986, you use the older male/female tables. The tables, IRS Tables I through IV, are in Publication 939. Table I, shown on page 147, is for single life expectancies. Table II, for ordinary joint life and last survivor annuities, is in Publication 939.

You may make an irrevocable election to use the unisex tables for all payments received under the contract, even if you did not make an investment after June 30, 1986.

If you invested in the contract both before July 1, 1986, and after June 30, 1986, and you are the first person to receive annuity payments under the contract, you may make a special election to use the prior tables for the pre-July 1986 investment and the unisex tables for the post-June 1986 investment. *See* IRS Publication 939 for further information. Treasury Regulation 1.72-6(d) has examples showing how to figure the post-June 1986 and pre-July 1986 investments.

Birthday nearest annuity starting date. In looking up single life or joint life expectancy in the applicable table, use your age (and the age of a joint annuitant) at the birthday nearest to the annuity starting date. The number in the table next to this age is the life expectancy multiple used to figure the tax-free and taxable portions of a monthly annuity; *see* the following Examples.

Adjustments for non-monthly payments. An adjustment is required when your annuity payments are received quarterly, semi-annually, or annually; *see* Example 3 below.

EXAMPLES

1. Bill Jones was 66 years old on March 14, 1996. On April 1, he received his first monthly annuity check of $1,000. This covered his annuity payment for March. Bill's annuity starting date was March 1, 1996, and his entire investment was before July 1, 1986.

   Looking at Table I on page 147 under "Male" at age 66 (age on birthday nearest January 1 starting date), Bill finds the multiple 14.4. (He does not have to adjust that multiple because the payments are monthly.) Bill multiplies the 14.4 by $12,000 ($1,000 a month for a year) to find his expected return of $172,800. Say the annuity cost Bill $129,600. He divides his expected return into the investment in the contract (the cost) and gets his exclusion percentage of 75%. In every year for the rest of his life, Bill receives tax free 75% of his annuity payments and is taxable on 25%. In 1996, Bill receives $9,000 ($1,000 in April through December) and reports $2,250 as the taxable amount:

Amount received	$9,000
Amount excludable	6,750
Taxable portion	$2,250

   For 1997 and later years, Bill will receive annuity payments for the full year. The amount received will be $12,000; amount excludable, $9,000; and taxable portion, $3,000.

2. Same facts as in Example 1 except there was an investment after June 30, 1986, and Table V is used. Looking at Table V under age 66, Bill finds the multiple 19.2. The same multiple applies to males and females. Multiplying the19.2 by $12,000 gives an expected return of $230,400. Using a cost of $129,600, the exclusion percentage is 56.25% ($129,600 ÷ $230,400). For 1996, Bill reports annuity income as follows:

Amount received	$9,000.00
Amount excludable	5,062.50
Taxable portion	$3937.50

   For 1997 and later years in which annual payments of $12,000 are received, the amount excludable will be $6,750, and the taxable portion, $5,250.

3. You receive quarterly annuity payments. Your first payment comes on January 15, covering the first quarter of the year. Since the period between the starting date of January 1 and the payment date of January 15 is less than one month, you adjust the life expectancy multiple according to the table on the bottom of page 147, by adding 0.1. If the life expectancy multiple from the IRS table was 14.4, the adjusted multiple is 14.5.

TABLE I: Investments Before July 1, 1986

Ages			Ages			Ages		
Male	Female	Multiples	Male	Female	Multiples	Male	Female	Multiples
6	11	65.0	41	46	33.0	76	81	9.1
7	12	64.1	42	47	32.1	77	82	8.7
8	13	63.2	43	48	31.2	78	83	8.3
9	14	62.3	44	49	30.4	79	84	7.8
10	15	61.4	45	50	29.6	80	85	7.5
11	16	60.4	46	51	28.7	81	86	7.1
12	17	59.5	47	52	27.9	82	87	6.7
13	18	58.6	48	53	27.1	83	88	6.3
14	19	57.7	49	54	26.3	84	89	6.0
15	20	56.7	50	55	25.5	85	90	5.7
16	21	55.8	51	56	24.7	86	91	5.4
17	22	54.9	52	57	24.0	87	92	5.1
18	23	53.9	53	58	23.2	88	93	4.8
19	24	53.0	54	59	22.4	89	94	4.5
20	25	52.1	55	60	21.7	90	95	4.2
21	26	51.1	56	61	21.0	91	96	4.0
22	27	50.2	57	62	20.3	92	97	3.7
23	28	49.3	58	63	19.6	93	98	3.5
24	29	48.3	59	64	18.9	94	99	3.3
25	30	47.4	60	65	18.2	95	100	3.1
26	31	46.5	61	66	17.5	96	101	2.9
27	32	45.6	62	67	16.9	97	102	2.7
28	33	44.6	63	68	16.2	98	103	2.5
29	34	43.7	64	69	15.6	99	104	2.3
30	35	42.8	65	70	15.0	100	105	2.1
31	36	41.9	66	71	14.4	101	106	1.9
32	37	41.0	67	72	13.8	102	107	1.7
33	38	40.0	68	73	13.2	103	108	1.5
34	39	39.1	69	74	12.6	104	109	1.3
35	40	38.2	70	75	12.1	105	110	1.2
36	41	37.3	71	76	11.6	106	111	1.0
37	42	36.5	72	77	11.0	107	112	0.8
38	43	35.6	73	78	10.5	108	113	0.7
39	44	34.7	74	79	10.1	109	114	0.6
40	45	33.8	75	80	9.6	110	115	0.5
						111	116	0.0

TABLE V: Investments After June 30, 1986

Age	Multiple	Age	Multiple	Age	Multiple
5	76.6	42	40.6	79	10.0
6	75.6	43	39.6	80	9.5
7	74.7	44	38.7	81	8.9
8	73.7	45	37.7	82	8.4
9	72.7	46	36.8	83	7.9
10	71.7	47	35.9	84	7.4
11	70.7	48	34.9	85	6.9
12	69.7	49	34.0	86	6.5
13	68.8	50	33.1	87	6.1
14	67.8	51	32.2	88	5.7
15	66.8	52	31.3	89	5.3
16	65.8	53	30.4	90	5.0
17	64.8	54	29.5	91	4.7
18	63.9	55	28.6	92	4.4
19	62.9	56	27.7	93	4.1
20	61.9	57	26.8	94	3.9
21	60.9	58	25.9	95	3.7
22	59.9	59	25.0	96	3.4
23	59.0	60	24.2	97	3.2
24	58.0	61	23.3	98	3.0
25	57.0	62	22.5	99	2.8
26	56.0	63	21.6	100	2.7
27	55.1	64	20.8	101	2.5
28	54.1	65	20.0	102	2.3
29	53.1	66	19.2	103	2.1
30	52.2	67	18.4	104	1.9
31	51.2	68	17.6	105	1.8
32	50.2	69	16.8	106	1.6
33	49.3	70	16.0	107	1.4
34	48.3	71	15.3	108	1.3
35	47.3	72	14.6	109	1.1
36	46.4	73	13.9	110	1.0
37	45.4	74	13.2	111	0.9
38	44.4	75	12.5	112	0.8
39	43.5	76	11.9	113	0.7
40	42.5	77	11.2	114	0.6
41	41.5	78	10.6	115	0.5

MULTIPLE ADJUSTMENT TABLE

If the number of whole months from the annuity starting date to the first payment date is —	0–1	2	3	4	5	6	7	8	9	10	11	12
And payments under the contract are to be made:												
Annually	+0.5	+0.4	+0.3	+0.2	+0.1	0.0	0.0	–0.1	–0.2	–0.3	–0.4	–0.5
Semiannually	+0.2	+0.1	0.0	0.0	–0.1	–0.2						
Quarterly	+0.1	0.0	–0.1									

¶7.24 When You Convert Your Endowment Policy

When an endowment policy matures, you may elect to receive a lump sum, an annuity, an interest option, or a paid-up life insurance policy. If you elect—

A lump sum. You report the difference between your cost (premium payments less dividends) and what you receive.

An annuity before the policy matures or within 60 days after maturity. You report income in the years you receive your annuity. *See* ¶7.22 for how to report annuity income. Use as your investment in the annuity contract the cost of the endowment policy less premiums paid for other benefits such as double indemnity or disability income. If you elect the annuity option more than 60 days after maturity, you report income on the matured policy as if you received the lump sum; *see* above rule. The lump sum is treated as the cost investment in the annuity contract.

An interest option before the policy matures. You report only the interest as it is received, provided you do not have the right to withdraw the policy proceeds. If you have the right to withdraw the proceeds, you are treated as in constructive receipt; the difference between your cost and what you receive would be taxed as if you had received a lump sum.

Paid-up insurance. You report the difference between the present value of the paid-up life insurance policy and the premium paid for the endowment policy. In figuring the value of the insurance policy, you do not use its cash surrender value, but the amount you would have to pay for a similar policy with the company at the date of exchange. Your insurance company can give you this figure. The difference is taxed at ordinary income tax rates.

Tax-free exchange rules apply to the policy exchanges listed at ¶11.8.

Sales of endowment, annuity, or life insurance policies are taxable as ordinary income, not as capital gains.

The proceeds of a veteran's endowment policy paid before the death of the veteran are not taxable.

Employee Annuities

	See ¶
Reporting employee annuities	7.25
Simplified rule for calculating taxable annuity	7.26
Cost of employee annuity	7.27
Beneficiary eligible for $5,000 death benefit exclusion	7.28
Withdrawals before annuity starting date	7.29
Civil Service retirement	7.30
Retired military personnel allowed annuity election	7.31

¶7.25 Reporting Employee Annuities

Tax treatment of your employee annuity payments depends on the amount of your contributions and your annuity starting date.

Fully taxable payments. If you did not contribute to the cost of a pension or employee annuity, and you did not report as income your employer's contributions, you are fully taxed on payments after the annuity starting date. On your 1996 return, you report fully taxable payments on Line 16b of Form 1040 or Line 11b of Form 1040A.

An employee is taxed on the full value of a nonforfeitable annuity contract which the employer buys him or her if the employer does not have a qualified pension plan. Tax is imposed in the year the policy is purchased. A qualified plan is one approved by the IRS for special tax benefits.

If your annuity started before July 2, 1986, and payments within the first three years under the contract exceeded your cost investment, payments were not taxable until they exceeded your cost investment. On your 1996 return, your payments are fully taxable.

Disability pension before minimum retirement age. Disability payments received before you reach the minimum retirement age (at which you would be entitled to a regular retirement annuity) are fully taxable as wages. After minimum retirement age, payments are treated as an annuity subject to the cost recovery rules of ¶7.22 or the simplified rules of ¶7.26.

Partially taxable payments. If you and your employer both contributed to the cost of your annuity, the part of each payment allocable to your investment is tax free and the balance is taxable.

On Form 1099-R, the payer of a pension or annuity may tell you how much is taxable. If not, you may make the tax-free calculation under either (1) the six-step method of ¶7.22, using IRS life expectancy tables found in Publication 939; (2) the "simplified" method explained at ¶7.26; or (3) for a $50 fee, ask the IRS to calculate the taxable amount. You may use the simplified rule only if your annuity starting date was after July 1, 1986, and is for your life or the joint lives of you and a beneficiary. Also, you may not use the simplified method if you are age 75 or over when the annuity commenced, unless there are less than five years of guaranteed payments.

Cost and cost adjustments are explained in ¶7.27 and ¶7.28.

Changing cost-recovery methods. You can switch from the regular six-step method to the simplified method or from the simplified to the regular method within the period for filing an amended return (¶38.1) for the first year. For example, if your annuity starts in 1996 and you use the six-step method, and realize within the amendment period that you could get a larger tax-free return with the simplified method, you may file amended returns for 1996 and later years using the simplified method to recompute your tax-free exclusion for all the years. Similarly, if your annuity began in 1993, 1994, or 1995, and you would like to switch methods, you may do so by filing amended returns (¶38.1) for the first year of the annuity and for any later years. After recomputing the tax-free percentage of each payment under the new method, use that same percentage every year until your investment has been completely recovered.

¶7.26 Simplified Rule for Calculating Taxable Employee Annuity

The simplified method disregards the IRS life expectancy tables that are required under the six-step method of ¶7.22, which you may find complicated. The tax-free recovery amount under the simplified method is generally larger than under the six-step method. Computations under both methods should be made, however, to determine the more advantageous method in your particular case. If you opt for the method resulting in the larger annual cost exclusion, you will get an immediate tax benefit but will accelerate the recovery of your cost investment and thus the time when benefits will become fully taxable.

Restrictions on using or switching to the simplified method. The simplified method may be used to figure the taxable portion of an annuity from a qualified employee plan or annuity, or from a tax-sheltered annuity (¶7.20), provided the annuity starting date was after July 1, 1986. The annuity must be either for your life, or for your life and your beneficiary's life. For a commercial annuity, the six-step method at ¶7.22 must be used.

The simplified method may *not* be used if you are age 75 or older when the annuity commenced, unless there are less than five years of guaranteed payments.

A beneficiary receiving a survivor annuity may use the simplified method if the employee used it.

Figuring taxable and tax-free payments under the simplified method. Under the simplified method, a level tax-free portion is determined for each monthly payment with the following steps.

Step 1. Figure your investment in the contract; *see* ¶7.27. Include premiums you paid and any after-tax contributions you made to the employer's pension plan. Beneficiaries may increase the investment by any allowable death benefit exclusion, up to $5,000, provided that proposed legislation to repeal the exclusion is not enacted; *see* ¶7.28.

Step 2. Divide the investment from Step 1 by the number of monthly payments shown in the following table, using your age at the birthday preceding the annuity starting date. The result is the tax-free recovery portion of each monthly payment. The tax-free portion remains the same if a spouse or other beneficiary receives payments under a joint and survivor annuity after the employee's death.

Age at starting date	Number of monthly payments *
55 and under	300
56–60	260
61–65	240
66–70	170
71 and over	120

* ***New Law:*** A new law increases the number of payments to be used in figuring the tax-free portion of each annuity payment: 300 increases to 360; 260 to 310; 240 to 260; 170 to 210; and 120 to 160. The age categories remain the same. The new law applies to annuities starting 90 days after the date of enactment. *See* the "What's New" page in the front of this book for the enactment date.

Step 3. Multiply the Step 2 result by the number of monthly payments received during the year; this is the total tax-free payment for the current year.

Step 4. Subtract the Step 3 tax-free payment from the total pension received this year; this is the taxable pension you must report on Form 1040 or Form 1040A. If the payer of the annuity shows a higher taxable amount on Form 1099-R, use the amount figured here.

EXAMPLE

Fred Smith, age 59, retires, and beginning January 1, 1996, he receives a single-life annuity of $1,000 per month. His investment in the plan was $30,000. To figure the tax-free portion of each payment, he divides his $30,000 investment by 260; *see* the table in Step 2 in the preceding column. The result, $115.38, is the tax-free portion of each monthly payment ($30,000 ÷ 260 = $115.38) and $884.62 ($1,000 – $115.38) is taxable. He reports $10,615 of his pension as taxable income (12 × $884.62); $1,385 is tax free (12 × $115.38). The $1,385 exclusion under the simplified method is $185 higher than under the six-step method using Table V at ¶7.23.

After 260 monthly payments, all further payments are fully taxable. If Fred dies before the receipt of 260 payments, a deduction for the unrecovered investment is allowed on his final income tax return; the deduction is a miscellaneous itemized deduction not subject to the 2% AGI floor.

¶7.27 Cost of Employee Annuity

For purposes of figuring the tax-free recovery of your investment under the general rules of ¶7.22 or the simplified rule of ¶7.26, include the following items paid as of the annuity starting date as your cost in an employee annuity:

- Premiums paid by you or by after-tax withholdings from your pay.
- Payments made by your employer and reported as additional pay.
- Premiums paid by an employer in a nonapproved plan for your benefit give you immediate income if you have nonforfeitable rights to the policy.
- Premiums paid by your employer, which, if the amounts had been paid to you directly, would have been tax free to you because you were working abroad; *see* Chapter 36.
- Pre-1939 contributions by a city or state to its employees' pension fund. (Before 1939, salaries to state and city employees were tax free for federal income tax purposes.)

If you are a beneficiary of a deceased employee, *see* ¶7.28.

¶7.28 Beneficiary Eligible for $5,000 Death Benefit Exclusion

The death benefit exclusion of up to $5,000 has been repealed. Repeal is effective for deaths occurring after the date of enactment of the new law. See the "What's New" page at the front of this book for the enactment date. For beneficiaries of employees who died in 1996 before the new law's enactment, the following death benefit exclusion rules apply.

Pre-repeal rules. As the beneficiary of a deceased employee or self- employed individual, you may be eligible for a death benefit exclusion of up to $5,000. If you are receiving a survivor annuity, add the exclusion to the cost of the annuity (¶7.27) to figure the tax-free and taxable portion of the payments under the simplified method (¶7.26) or general method (¶7.22).

If you are a beneficiary using the simplified reporting method, do not rely on the taxable amount entered in Box 2a of Form 1099-R by the employer because the employer does not take into account the exclusion. If as a beneficiary you receive a one-time death benefit payment that is *not* made from an employer retirement plan, report as "Other income" on Form 1040 the excess of the payment over the allowable death benefit exclusion.

The death benefit exclusion is fixed at $5,000 per deceased employee, without regard to the number of beneficiaries or employers funding pension payments. The $5,000 exclusion must be allocated among beneficiaries in proportion to their benefits.

If you are the survivor under a joint and survivor annuity, you may *not* claim the death benefit exclusion if the deceased had received any payment under the joint and survivor contract after reaching minimum retirement age.

Beneficiaries of self-employed individuals may claim the death benefit exclusion for distributions from a qualified pension or annuity plan.

¶7.29 Withdrawals Before Annuity Starting Date

You generally may not make tax-free withdrawals from your employer's plan before the annuity starting date, even if your withdrawals are less than your investment. On a withdrawal before the annuity starting date, you must pay tax on a portion of the withdrawal unless the exceptions below apply. The portion of the withdrawal allocable to your investment is recovered tax free; the portion allocable to employer contributions and income earned on the contract is taxed. To compute the tax-free recovery, multiply the withdrawal by this fraction:

$$\frac{\text{Your total investment}}{\text{Your vested account balance or accrued benefit}}$$

Your investment and vested benefit are determined as of the date of distribution.

Exceptions. More favorable investment recovery rules are allowed in the following cases:

1. *Employer plans in effect on May 5, 1986.* If on May 5, 1986, your employer's plan allowed distributions of employee contributions before separation from service, the above pro-rata recovery rule applies only to the extent that the withdrawal exceeds the total investment in the contract on December 31, 1986.

   For example, assume that as of December 31, 1986, you had an account balance of $9,750, which included $4,000 of your

own contributions. If the plan on May 5, 1986, allowed pre-retirement distributions of employee contributions, you may receive withdrawals up to your $4,000 investment without incurring tax. Thus, if you have not made previous withdrawals and receive a $3,000 distribution in 1994, it is not subject to tax.

2. *Separate accounts for employee contributions.* A defined contribution plan (such as a profit-sharing plan) is allowed to account for employee contributions (and earnings on the contributions) separately from employer contributions. If separate accounting is maintained, withdrawals of employee contributions from the separate account may be made tax free. A defined benefit pension plan may also maintain employee contributions (and earnings) in a separate account to which actual earnings and losses are allocated.

Note: Both of the exceptions just discussed are complicated and you should consult your plan administrator to determine if the exceptions apply and how to make the required calculations.

¶7.30 Civil Service Retirement

You may use either the general rules of ¶7.22 or the simplified rule at ¶7.26 to compute the tax-free and taxable portions of each withdrawal for an annuity starting after July 1, 1986. If your annuity starting date was before July 2, 1986, and you used the three-year cost recovery rule, all of your annuity payments are now fully taxable.

If you leave federal government service before retirement or transfer to a job not under the federal retirement system and you are not entitled to an immediate annuity, you may receive a refund of your contributions (plus any interest). If the refund exceeds your contributions, the excess is taxable.

Retirees with a life-threatening illness may be able to elect a reduced annuity in order to receive a lump-sum credit for their total contributions to the plan; *see* IRS Publication 721 for figuring the taxable portion of the lump sum if the election was made.

Cost of civil service annuity. For purposes of figuring the tax-free portion of each annuity payment under the rules of ¶7.22 or ¶7.26, your *cost* equals the withholdings from your federal government pay that were contributed to the Civil Service retirement fund. Also, if you repaid to the retirement fund amounts that you previously had withdrawn, or paid into the fund to receive full credit for certain uncovered service, the entire amount you paid, including that designated as interest, is part of your cost. You may not claim an interest deduction for any amount designated as interest.

The annuity statement you received when your annuity was approved shows your "total contributions" to the retirement fund (your cost) and the "monthly rate" of your annuity benefit. The monthly rate is the rate before adjustment for health benefits coverage and life insurance, if any.

A future increase in your civil service pension or your survivor's benefit is not treated as annuity income but is reported in full as miscellaneous income and is not reduced by the exclusion ratio. However, an increase effective on or before a survivor's civil service annuity commences must be taken into account in computing the expected return or in determining the aggregate amount receivable under the annuity.

A lump-sum payment for accrued annual leave received upon retirement is not part of your annuity. It is treated as a salary payment and is taxable as ordinary income.

If you made voluntary contributions to the retirement fund that you use to fund an additional monthly benefit, you report the portion of your annuity attributable to the voluntary contributions as a separate annuity, taxable under the rules at ¶7.22 or ¶7.26. If you made voluntary contributions, an information return which you receive each year will state the portion of your monthly payments attributable to your voluntary contributions. If instead of increasing your monthly benefit you receive a refund of your voluntary contributions plus accrued interest, the interest is taxable in the year you receive it.

¶7.31 Retired Military Personnel Allowed Annuity Election

If, when you retire from the military, your pay is reduced to provide an annuity for your spouse or certain child beneficiaries, you do not report that part of your retirement pay used to fund the annuity.

For example, you are eligible to receive retirement pay of $500 a month. You elect to receive $400 a month to obtain an annuity of $200 a month for your spouse on your death. You report $400 a month for tax purposes during your lifetime, rather than the $500. On your death, your spouse generally will report the full $200 a month received as income.

If you received retirement pay before 1966 and elected reduced benefits, you reported more retirement pay than you actually received. In this case, amounts attributed to the reduction in retirement pay reported in prior years offset retirement pay received in 1966 and later years.

Veteran's Benefit Deposits. If you elected to receive veteran's benefits instead of some or all of your retirement pay, you may have been required to deposit with the U.S. Treasury an amount equal to the reduction for the annuity. If so, you do not report retirement pay until it equals the amount deposited.

Beneficiaries. If all of the retired person's consideration for the contract (previously taxed reductions) has not been offset against retirement income at the time of death, the beneficiary excludes all payments under the contract until the exclusions equal the remaining consideration for the contract not previously excluded by the deceased. As soon as this amount is excluded, the beneficiary reports all later payments as income.

The $5,000 death benefit exclusion (¶7.28) is treated as a cost investment to be added to the spouse's annuity contract if the deceased service member retired because of disability and dies before reaching retirement age.